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THE INTERNATIONAL ECONOMY

By

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PREFACE

The major events of the past decade have shaped the revision of this book into what is practically a new volume. Like earlier editions, it seeks to set forth as clearly and simply as possible the essential features and theoretical bases of the international economy. Aiming at reasonable completeness, the book covers a wide variety of subjects, attempting a balance among history, description of institutions, theory, and policies.

The book is intended not only for college students but also for the many others who seek information and understanding of international economic affairs and of the major role which the United States plays in these affairs today.

The subject matter has been selected on the basis of relative and continuing significance. Fundamental theory ranks high on this basis, and the theoretical chapters thus comprise a considerable part of the book. In a presentation of theory there is always the question of where to begin; should monetary theory precede or follow trade theory? In this book the theory of money and foreign exchange is considered first.

The length of the policy section reflects the growing importance of international economic policies. I have endeavored in this section to present a reasonable amount of background information and to bring out the essential issues involved. Economic policies, closely interwoven with political policies, determine to a large extent the living standards of people throughout the world. People everywhere want peace, freedom, and a chance to earn economic advancement. These objectives are visualized more clearly than are the means of attaining them. Lack of understanding, pressure from interested groups, and misrepresentation confuse the choice of policies and procedures.

Students of international economic policies cannot fail to be impressed by the vast expansion in production and consumption that would occur throughout the world if nations were to

pursue policies and procedures which do not do violence to sound economics (if I dare use the term). In the United States, despite frequent lapses from sound economic policy, production has gone ahead in spectacular fashion. To a considerable extent, this development is attributable to the fact that individual initiative is given reasonably free rein over a large territorial area and that restrictions are fewer than in most countries. It was more than chance that the previous expansion in England and other countries coincided with the growth of liberalism.

Pressures toward expanded production and higher living standards are powerful, but are held back by burdensome restrictions, among other things, based often on nationalistic grounds. Trade liberalization involving a breaking down of barriers and the establishment of firm international cooperation, much more than has yet been achieved, are essential to full expansion.

Economic policies in many countries at present give primary emphasis to facilitating economic development. The people of underdeveloped areas are demanding that their primitive and long-neglected conditions receive urgent attention. In advanced countries the public is becoming aroused to the need, but the problem is so large that, although notable progress is being made, measures taken to date are little more than a beginning.

People also will no longer tolerate depression and unemployment. They insist that, since governments have made industry produce for war and defense, they make it produce for peace, and that the fruits be widely distributed. The United Nations has taken special interest in these problems, all of which offer a challenge to the student of international economic affairs.

An encouraging trend is the widespread increase in understanding of economic principles. Only a decade or two ago, government administrators who had a comprehension of economic principles were not numerous. Governmental and intergovernmental discussions of economic questions today take place on a level which assumes a broad grasp of fundamental economic principles. For example, discussions centering on the International Monetary Fund (IMF), the European Payments Union (EPU), or the General Agreement on Tariffs and Trade

(GATT) indicate the widespread advance in technical economic understanding. This advance, unfortunately, does not mean that policies pursued necessarily conform to good economics, but progress is being made in understanding of the economic issues involved.

It is hoped that this book will contribute to the increasing understanding of international economic questions, on which economic and political progress so much depends.

In the preparation of this book I have received generous assistance from a large number of people, especially in governmental and international agencies. While it would be inappropriate to list their names and thus imply official approval of the sections they reviewed, I am none the less very grateful to them. For a careful review of the theoretical chapters I am indebted to Professor Raymond Mikesell of the University of Virginia. The views expressed in the book do not, of course, necessarily represent those of the State Department or of any other governmental agency.

JOHN PARKE YOUNG

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CONTENTS

PART I

History and Methods of International Trade

PART II

Theoretical Analysis

PART IV

The Course of International Finance

ILLUSTRATIONS

TABLES

PART I

HISTORY AND METHODS OF INTERNATIONAL TRADE

Chapter 1

THE NATURE OF INTERNATIONAL TRADE

Dual Nature of Trade.—Trade and other economic contacts between nations have expanded greatly in modern times. The mass movement of commodities, often over great distances, has made available many articles which otherwise could not be enjoyed and has raised standards of living. Because of foreign trade we have both a greater amount and a greater variety of goods to consume.

The growth of foreign trade has gone hand in hand with technological improvements in production and with the development of transportation. These advances have made possible the large increases in the volume and variety of goods produced and traded. Factories turn out quantities of commodities, large and small, which are not consumed locally but are promptly distributed to the four corners of the world. Progress in transportation and the expansion of world markets have made possible this large-scale and economical production.

Many articles of ordinary daily use come to us from distant parts of the world. Our shoes may have been made in St. Louis, but the leather perhaps came from the Argentine. The wool in our clothes was sheared perhaps from sheep in Australia and spun into cloth in Manchester, England. Our coffee may be from Brazil or Colombia and the sugar from the Philippines or Cuba. Much of our butter comes from Denmark, chocolate comes from West Africa or South America, and the tin in which it is packed may be from Malaya or Bolivia. The paper in our morning newspaper probably came from wood pulp from Canadian forests or perhaps from Finland. Rubber which the United States imports from the Malay Peninsula, Indonesia, or Africa may return to its native land in the form of automobile

tires. Corks for our numerous bottles come from Algeria and Portugal, and the shellac on our furniture is probably from India.

The continuous flow of goods in and out of a country and the dependence of every nation upon foreign sources for many articles, frequently items of special importance, are making the world an integrated economic unit. As a result of the extensive shipments of commodities and of magazines and moving picture films and the interchange of technology, nations are being fitted more and more to a similar pattern of living and thinking. The intimate relations of each nation with other nations, economic, financial, and cultural, tend to reveal the artificial nature of national boundaries. Reluctance of nations, however, to recognize fully, in both the economic and political fields, their community of interests and the degree of cooperation required in the modern world is tending to retard a solution to many problems.

All trade, whether domestic or foreign, government or private, is the exchange of goods or services of one party for the goods or services of another party. Trade thus has two sides. When we speak of Brazil sending coffee to the United States, we mean that individuals or businesses in the United States have bought coffee from individuals or business houses in Brazil. Brazilians thereby acquire dollars with which they can in turn purchase foreign goods. The imports and exports of the United States are made up of thousands of transactions that have been the result of negotiations between someone in the United States and someone in a foreign country. Individual traders decide what to buy and when, where, and how much to buy. The aggregate of these transactions amounts to several billion dollars and consists of goods given and goods received in return. Trade between nations was formerly carried on almost entirely by private individuals. In recent years, however, governments have increasingly engaged in foreign trade, directly or indirectly. Many foreign trade transactions are now the result of governmental decisions.

The dual nature of trade, whether carried on privately or by government, is often overlooked and thereby becomes a source of confusion. Goods exported pay for goods imported, which

fact is fundamentally the principal reason for their exportation. When a person barters one article directly for another article, the simple nature of the trade is clear. Similarly, foreign trade is an exchange of our goods or services for those of a foreigner. The interjection of money and bills of exchange into transactions does not change their essential nature. The fact that foreign trade is conducted in terms of money, rather than by barter (except in special cases) and that the person who exports goods receives money instead of other merchandise—the domestic importer of the other merchandise being a different person from the exporter—tends to conceal the real nature of the trade. If we as a nation export but discourage imports from abroad, we are parting with goods and services but making it difficult for the foreigner to pay us. If a country endeavors to push unduly either its exports or its imports, it may create an unbalanced condition in its trade which will sooner or later be the source of trouble. Before the second World War some nations were inclined to "overexport," that is, to seek foreign markets to the point that they were selling more than they were willing to buy. The United States was guilty of this unbalanced stimulation of exports. Since the war, the tendency of many nations has been to "overimport," that is, to buy beyond their means to make payment through exports.

Goods exported to foreign countries are sometimes referred to as surplus goods, the implication being that we produce more than we can consume at home and therefore export the surplus. It is true that a producer may find himself overloaded with more goods than he can profitably sell and so seek an additional market in which to dispose of the surplus, a market which may or may not be abroad. Producers, however, normally produce for a definite market, and the foreign market is no more an outlet for surplus goods than is the home market. Potatoes grown by a farmer who grows more than he can himself consume are not regarded as surplus potatoes. Similarly, goods produced by American firms and sold abroad are not surplus goods in any legitimate sense.[1]

[1] See an explanation of the word "surplus" in Chapter 32, "Commodity Problems and Agreements."

Foreign Trade and Domestic Trade.—Domestic trade and foreign trade are in many respects similar, but there are important differences. Although goods may travel thousands of miles, the trade remains domestic if they do not cross a political boundary. The minute they cross a border, the trade becomes foreign trade. This difference may seem artificial, but a political boundary is a matter of considerable consequence.

In the first place, the border usually involves a barrier to the free movement of goods. Various regulations and restrictions such as tariffs and licenses make more difficult, and sometimes impossible, the shipment of goods across a border. Such barriers to trade have increased greatly since the 1930's and they tend to discourage trade.

Second, the buyer of foreign goods must pay for them in a different kind of money from that which he is accustomed to use in his own country; or, if the buyer is permitted to pay in his own kind of money, the seller must convert the proceeds into his (the seller's) kind of money. If a man in Boston buys goods from a man in Montreal, the Canadian seller must receive payment in American dollars, or the American buyer must purchase a draft payable in Canadian dollars. Whatever may be the arrangements agreed between buyer and seller, foreign transactions necessarily involve the conversion of one kind of money, the money paid by the buyer, into another kind of money, the money used by the seller, unless the seller should wish to leave the proceeds of the sale abroad. Such conversion may involve serious difficulties.

Third, the foreign market usually has a variety of differences from the local market. Foreign purchases and sales are subject to different laws. Traders also have to contend with differences in customs, institutions, and language. This condition affects the kinds of commodities shipped as well as the conduct, procedures, and course of foreign trade. Trade tends to flow more freely between countries having similar racial, cultural, and political institutions. Domestic trade, it is true, frequently has to consider differences in markets, but rarely in the same degree as in the case of foreign trade; most countries are relatively homogeneous within themselves. Goods destined for a

foreign market must often be of a type different from those prepared for the domestic market, and they may be sold under different conditions. For example, automobiles for export are sometimes manufactured with a right-hand drive.

Fourth, domestic goods sold in foreign trade are produced under a set of costs and conditions different from those which prevail in the foreign market. Wage rates, the prices of materials, and the cost of capital, the so-called factor costs, vary widely from country to country and are affected by political boundaries. Taxation, governmental regulations, and other national conditions influence costs to an important degree. Labor, materials, and capital are much more mobile within a country than between countries, so that substantial differences in relative costs exist. The producers in one country may not compete to any great extent with foreign producers for the same laborers or other factors of production. Such lack of competition between different parts of the same country sometimes exists, but factor costs do not ordinarily vary as greatly within a country as between countries.

In the United States exports and imports are not so large a percentage of the country's total domestic trade as is the case in most other countries. Production in the United States is widely diversified, so that the country is less dependent upon outside sources than would be the case if domestic production were concentrated on a few products. In the United States exports constitute only about 5 to 8 per cent of the national income, and imports are ordinarily an even lower percentage. In underdeveloped countries where standards of living are low, foreign trade is also ordinarily a small percentage of national income, but for different reasons. In such countries the great bulk of production is usually of a fairly simple nature, consisting of agricultural products for local consumption and of simple manufactured articles, also largely for the local market.

On the other hand in advanced countries with high per capita incomes and specialized industry or agriculture, such as Canada, Norway, Switzerland, and Belgium, foreign trade constitutes a large percentage of national income. In such countries the public consumes a wide variety of products other than basic

essentials locally produced. The specialized nature of their production requires the foreign market as an outlet. In these countries exports and imports range from about 20 to over 40 per cent of the national income. In the United Kingdom imports amount to from 15 to 20 per cent, and exports to from 10 to 15 per cent, of the national income.

Chapter 2

HISTORY OF INTERNATIONAL TRADE

Beginnings of International Trade.—If we turn back the pages of history to remote antiquity, we find traces of an extended commerce. These early periods of commerce, however, are shrouded in mystery and legend. While we do not know much about the extent or nature of this trade of the ancients, we know that it existed and involved long distances. For perhaps several thousand years before present European countries took form, commerce existed between such widely separated points as China, India, and the Baltic regions of northern Europe. By the fourth century B.C. Greece was regularly receiving raw silk from China and weaving it into cloth, which was extremely expensive. Whether ancient trade came in contact with the Western Hemisphere we can only surmise, but Carthaginian coins have been found in the Azores, nearly half way across the Atlantic. Figures Oriental in nature have been found in the ancient ruins of Mexico and also in other parts of the Americas.

From earliest times, commerce has contributed greatly to the progress of mankind. Through trade, the civilization and cultures of the more advanced peoples have spread into backward areas and stimulated progress there. The search for trade routes has led to the discovery of new regions, and to their consequent development. As a result of trade, different civilizations have met, often with a clash, but each has benefited by the other. Trade brings new methods and new ideas; it also carries much of the undesirable along with the good. Throughout history trade has gradually tended to break down the differences and contrasts of trading areas. Today the entire world lives increasingly the same general type of life. It sees the same

movies, wears similar kinds of clothes, rides in the same kinds of automobiles, and dances to the same music.

International commerce appears to have developed very early along the traveled desert routes, thousands of years before Christ. Caravans of camels driven by Arab nomads carried the wares of ancient northern Africa to be exchanged for the products of the civilizations of the Tigris-Euphrates Valley, Babylonia, and later Assyria. The Arabs, familiar with the desert, established oases as entrepôts and resting stations in connection with this trade. Organized in large caravans to ward off marauders, the Arab traders themselves became robbers when such operations attracted them. Whether traders or brigands, they would dispose of their wares in colorful bazaars, where dates, wool, and garments were exchanged for olive oil, spices, drugs, dyes, and ornaments. Goods carried on these caravans were necessarily those which combined high value with small bulk, principally luxuries. Necessities did not as yet figure in long-distance trade. Later, products were traded between Egypt and Mesopotamia along the Tigris and Euphrates rivers. Shipments included timber, stone, and corn, in addition to the other goods mentioned.

Little is known about the trade of the early civilizations in the Western Hemisphere, but it is apparent that considerable trade existed there. In China, trade appeared several thousand years before Christ, and contributed to the civilization of that period. Until the last few centuries, China was self-satisfied and did not encourage foreign traders. Nonetheless, trade with foreign nations took place, largely on the initiative of the foreigners. The modern period of trade between China and the West dates from 1516, when European sailors appeared at Canton. Japan was not opened to foreign trade until the middle of the last century.

The first important seagoing people appear to have been the inhabitants of the island of Crete, in the eastern Mediterranean. From about 2500 to 1500 B.C., the Cretans maintained a commerce which embraced Egypt, Sardinia, and the Aegean area. Articles traded included such luxury products as paintings, sculpture, gems, pottery, ivory, fine fabrics, and inlaid

work. Egypt and Mesopotamia were still great powers when the sea assumed a commercial importance.

During these early periods, and in fact until recent times, commerce has had to contend with robbers and pirates. Commerce was seriously hampered by the unsafe conditions of travel. Traders ordinarily had to provide their own protection, and the difference between a trader and a pirate often was not great. Another great handicap to trade was the inadequacy of transportation facilities. Only in modern times has transportation permitted the mass movement of commodities over great distances and made foreign articles generally available to the common man.

The Phoenicians.—The Cretan Age came to an end with the rise of the Phoenicians, an energetic Semitic race which inhabited the eastern shores of the Mediterranean. The Phoenicians established the great trading cities of Tyre and Sidon in Syria and the colony of Carthage on the North African coast. Carthage, founded before 800 B.C., eventually overshadowed all the other Phoenician cities.

The Phoenicians were pioneers in the art of shipbuilding and made frequent voyages to the western Mediterranean and beyond. Shut off from the inland by a range of mountains, the Phoenicians logically took to the sea. For four centuries the Phoenicians were a pre-eminent maritime people, carrying on a thriving commerce between the various regions of the entire known world. Metal articles, glassware, and textiles were shipped to the western Mediterranean peoples in exchange for tin, copper, and silver. The Phoenicians controlled and worked copper mines in Spain. A great land trade was established with Central Africa, from which ivory, Negro slaves, and gems were secured and sold to the Mediterranean peoples. The Phoenicians also established commercial relations with India, which they reached by crossing the Isthmus of Suez. In exchange for the products of the East, the Phoenicians shipped gold and spices from Asia Minor and Arabia, tin from Gaul, iron from Lorraine, corn and linen from Egypt, slaves from Africa, and wine from Italy and Greece.

The extent of the rich commerce of Tyre as it existed in this early period is indicated from the following biblical passage written some time about the sixth century B.C. by the prophet Ezekiel:

> Tyre, O thou that dwellest at the entry of the sea, which art the merchant of the peoples unto many isles, . . . thy borders are in the heart of the seas; thy builders have perfected thy beauty. They have made all thy planks of fir trees from Senir; they have taken cedars from Lebanon to make a mast for thee. Of the oaks of Bashan have they made thine oars; they have made thy benches of ivory inlaid in boxwood, from the isles of Kittim. Of fine linen with broidered work from Egypt was thy sail, that it might be to thee for an ensign; blue and purple from the isles of Elishah was thine awning. . . .
>
> Tarshish was thy merchant by reason of the multitude of all kinds of riches; with silver, iron, tin, and lead, they traded for thy wares. Javan, Tubal, and Meshech, they were thy traffickers: they traded the persons of men and vessels of brass for thy merchandise. They of the house of Togarmah traded for thy wares with horses and warhorses and mules. The men of Dedan were thy traffickers: many isles were the mart of thy hand: they brought thee in exchange horns of ivory and ebony. Syria was thy merchant by reason of the multitude of thy handiworks: they traded for thy wares with emeralds, purple, and broidered work, and fine linen, and coral, and rubies. Judah, and the land of Israel, they were thy traffickers: they traded for thy merchandise wheat of Minnith, and pannag [perhaps a kind of confection], and honey, and oil, and balm. Damascus was thy merchant for the multitude of thy handiworks, by reason of the multitude of all kinds of riches; with the wine of Helbon, and white wool. Vedan and Javan traded with yarn for thy wares: bright iron, cassia, and calamus were among thy merchandise. Dedan was thy trafficker in precious cloths for riding. Arabia, and all the princes of Kedar, they were the merchants of thy hand; in lambs, and rams, and goats, in these were they thy merchants. The traffickers of Sheba and Raamah, they were thy traffickers: they traded for thy wares with chief of all spices, and with all precious stones, and gold. Haran and Canneh and Eden, the traffickers of Sheba, Asshur, and Chilmad, were thy traffickers. They were thy traffickers in choice wares, in wrappings of blue and broidered work, and in chests of rich apparel, bound with cords and made of cedar, among thy merchandise. The ships of Tarshish were thy caravans for thy merchan-

dise: and thou wast replenished, and made very glorious in the heart of the seas.[1]

Early Forms of Money Used in Commerce.—Various forms of money were in use prior to the Phoenician period, but it appears that in the commerce of the Phoenicians most of the exchanges were made on the basis of goods.

At what date gold and silver came into use as money to help transact trade is not known, but there is evidence that in Babylonia and Egypt some three or four thousand years before Christ, gold and silver, particularly silver, were used as money in the form of uncoined bars. They were accepted entirely by weight. Gold bullion apparently served as money in China about two thousand years before Christ. About 1100 B.C. is the date of records of small gold cubes circulating there. Money appears to have been coined in China about 600 B.C.

Coins first appeared in the Mediterranean countries in Lydia about 700 B.C. and were in the form of crude pieces of metal with a seal stamped on them. Croesus minted gold coins there in the sixth century B.C. from gold obtained from his famous gold mines. Most of the metallic money in these early periods was in the form of lumps, bars, or rings. They were stamped to show their weight and also had the inscription of the ruler. Darius the Great of Persia made a gold coin about 500 B.C. which circulated widely for several centuries. It was the first gold coin to circulate in Greece. The Greeks were instrumental in extending the use of coined money, and Athens maintained a silver currency which gained wide acceptance. Bronze money was coined in Rome about 300 B.C. but later gave way to the more convenient silver money. By about 200 B.C. silver was the dominant standard in Rome and continued so for several centuries. Gold coins were also struck but did not supplant silver as the basic metal until about the fourth century A.D.

Commodities of various types have served as money from the very earliest times and even down to the present in outlying parts of the world. Commodities so used include cattle,

[1] Ezek. 27:3-7, 12-25.

sheep, knives, skins, shells, pieces of cloth, grain, cacao, tobacco, olive oil, rice, salt, and many other articles. Iron money circulated in Sparta, and uncoined copper in ancient Rome. Leather representative money was used in Carthage.

In China the use of paper money was fully developed in very early times. Other countries lacked paper but used other materials instead as representative money. In China, over a century before Christ, one of the emperors issued white leather tokens made from white deer, after all of this type of deer had been corralled in a park so that no one else could put out similar money. Marco Polo, in the thirteenth century, found paper money of various values circulating in China. Although paper money has been used for many centuries, the present widespread use of it is a modern development. The history of paper money throughout the various parts of the world records frequent abuse, overissue, and depreciation, with disturbing effects upon trade and commerce.

Greek and Roman Commerce.—The Phoenicians eventually relinquished maritime supremacy to the Greeks, and were driven out of the Aegean and Ionian Seas. By 500 B.C., Greek commerce had assumed substantial proportions, and it helped to provide the economic foundation for Greek culture. The wealth of Greece was immeasurably increased by the activities of its energetic traders and shippers. The Greeks exported olive oil, figs, honey, pottery, fabrics, and metals. With the conquests of Alexander in the fourth century B.C., the Greeks were enabled to develop a trade with Central Asia. Trade was also carried on with India. As a result of Greek commerce, the cities of Antioch and Alexandria in the eastern Mediterranean came to have great importance as trading centers.

The Romans were less commercial in temperament than the Greeks, and during their early development they showed little interest in trade. Commerce, however, was an inevitable accompaniment of imperial aspirations. The extension of the Roman Empire and the establishment of law and order over so much of the known world gave commerce a more solid foundation than ever before. The entire known world at that time was united

in trade, which extended from China to Britain and the Baltic regions in northern Europe. During the *pax romana,* or period of peace, which began in 29 B.C. and lasted for over two centuries, Rome enjoyed great prosperity and trade flourished without disturbance. Roman commerce followed the general pattern laid down by the Greeks. Trade between East and West was greatly expanded. About the middle of the first century A.D., the secrets of the monsoon winds in the Indian Ocean were discovered, and the monsoons facilitated navigation to India.

Commodities entering into commerce during this era were marble from Greece, flax and papyrus from Egypt, metals from Britain and Asia, glass and leather from Gaul, perfumes from Syria, ivory, ebony, and slaves from Africa, silk from China, furs and gems from Scythia, hides from Asia Minor, parchment from Pergamum, amber from the Baltic and Germany, and timber from Syria and Africa. Rome imported large quantities of corn from Egypt to support its growing population.

Byzantine Commerce.—With the fall of Rome in the fifth century, Constantinople became the great commercial center of the world and continued supreme in this capacity until the time of the Crusades. Constantinople acquired a wide reputation for its excellent manufactures. Its porcelains, fabrics, exquisitely engraved metal articles, carved ivories, and mosaics were highly prized in the markets of East and West.

Mohammedanism emerged in the early seventh century in Arabia and spread rapidly. In 637 the Arab disciples of Mohammed, known as Saracens, captured Antioch, and in 641 they subdued Alexandria. The conquest of other countries continued until the Saracen dominion included Persia, Syria, Egypt, North Africa, and Spain. During the seventh and eighth centuries the Arab disciples of the new religion were the outstanding traders of the world. At first the Saracens placed their militant religion before trade. Gradually, however, their commercial interests took more and more of their attention. The Saracens visited China regularly and carried on a thriving trade with India. In Spain and Sicily they introduced Eastern agri-

cultural plants and industries, thus affecting the commerce of these regions.

Several of our modern institutions for facilitating trade, such as banking and insurance, had their beginnings in Constantinople. Credit notes were used, and loans were available at relatively moderate rates of interest. The monetary unit was the gold bezant, which found general acceptance. Token money in the form of iron coins circulated for smaller transactions. Facilities were also developed for insuring shipments of merchandise. Great fairs were instituted at Constantinople and Thessalonica where traders from all over the world could dispose of their wares. At these fairs a high degree of freedom of trade prevailed. The Saracens devised the Arabic or decimal system of notation and improved notably the scientific learning and culture acquired from earlier civilizations.

Characteristics of Medieval Trade.—International trade during the early Middle Ages was relatively small in volume. With the decline of Roman roads and the general disorganization accompanying the barbarian invasions, commerce almost disappeared. The network of highways from Persia on the east to Britain on the west fell to pieces. The independent nobles lived a simple and local life. In Italy, however, trade did not completely die out, as noted in the next section.

During this period each feudal manor was a self-sufficient unit in which practically all the necessities of life were produced. Salt and a few other items, however, were acquired from outside by trade. The principle of trade was condemned by the Church. Trade was considered barren, and it was believed that if one party to a trade gained, the other party lost. Traders were usually unbelieving Jews and Arabs, and they were scorned as a class by Christians.

With the rise of towns, this narrow conception of trade became outmoded, and commerce ceased to be looked upon as an illegitimate occupation. The development of guilds, with various social and religious as well as business functions, gave dignity to the status of the merchant. Every town had a market place where, on certain days, goods made by craftsmen could

be exchanged for farm produce. Goods could be traded only at the market place and only on market days. What the market place was to a town, the fair was to a larger region. Fairs were generally held once a year and were frequented by merchants from outside countries who often came long distances. Goods of every description and from many localities were brought here and were bought and sold.

Except at the fairs, medieval commerce was subject to numerous restrictions. Guilds exercised strict regulation over prices and workmanship. Each guild, moreover, monopolized a particular industry in the town in which it was located, so that competition was absent. Trade between different areas was impeded by numerous customs, duties, tolls, and taxes. The movement of commodities between towns, provinces, and foreign countries thus had to contend with many barriers of this nature and was seriously handicapped. The modern system of various restrictions on trade thus has its roots in medieval practices.

Commerce of the Italian Towns.—The heirs to the commerce of Constantinople were the independent cities of Venice, Genoa, Naples, Florence, Milan, Pisa, etc. Even before the Crusades, the Italian towns had developed a considerable Mediterranean commerce. The Crusades, however, enabled them to extend their activities greatly. Out of the intense rivalry between these towns, Venice emerged supreme and became the most powerful city of the Middle Ages.

In the eleventh century, the Arabs were driven from Sicily and the Christians assumed the offensive in the wars of religion. The Crusades, which had for their objective the recovery of the Holy Land from the Saracens, began in 1095 and covered a period of almost two centuries. The fleets accompanying these Crusades were fitted out with munitions and food by merchants in Venice, Genoa, Pisa, and other Italian ports. The merchants saw to it that they were rewarded for their services by having assigned to them a definite quarter in a captured town where their trade could be centered. Venice sent governors to Jerusalem to preside over the quarters there that had been assigned to its citizens. The Italian cities received coveted com-

mercial concessions in Syria and Palestine and developed an active trade with this area. After the Fourth Crusade, Venice seized important provinces of the Byzantine Empire.

Italian bankers engaged in extensive banking operations and succeeded in replacing, to a large extent, the Jews who had monopolized this field. During the late twelfth and early thirteenth centuries the Papacy set up extensive financial machinery and made use of the facilities of the Italian bankers. They were protected by the Church from the ban on usury, and, in spite of their high interest rates, they were an aid to the commerce which was emerging from the Dark Ages. They loaned money, received deposits, and employed bills of exchange. The Florentines, Lombards, and Venetians established agencies in the principal cities of Europe to carry on the financial affairs of the Church. The street in London where the Lombards lived and followed their occupation became known as Lombard Street, and is today the principal financial street in London. Commerce was greatly facilitated by the development of banking and improvements in the keeping of accounts. The coinage of this period was in bad shape and handicapped trade. Banking tended to relieve this situation somewhat by helping to standardize monetary units for accounting purposes. The Venetian gold ducat was first coined in 1284 and became the leading currency of the world.

The Crusades revived the trade between Europe and the East and paved the way for the subsequent great expansion in this commerce. The Crusaders returned from Palestine much impressed with the comforts and luxuries of their foes. Such luxuries as window glass, artificial light, and chimneys were introduced into Europe as a result of the Crusades, and gradually a large demand for Eastern spices, silks, calicoes, perfumes, and gems was developed. Other Eastern products were camphor, musk, pearls, carpets, ivory, and porcelain from China. These wares eventually found their way through the Italian cities into France, Germany, and other parts of Europe, where the people marveled at these luxuries.

These new goods and the desire to possess them stimulated production in Europe. The effects of their introduction into

Europe were profound. The people endeavored to produce a surplus of goods over their own needs so that they might have goods to trade for these Eastern luxuries. European production thus expanded greatly. Cloth manufactured in England, France, Flanders, and Italy was shipped regularly from the Italian ports to the East, as were wines and other goods. A special market for Western cloth was established in Cairo. The exports of Europe, however, were inadequate, so that gold and silver left Europe in large quantities to pay for the imported articles.

As the precious metals were drained from Europe to the East, their value increased, or, in other words, commodity prices declined. This appreciation of gold and silver stimulated the search for the metals and led to the explorations in America. The principal aim of the explorers was to obtain treasure. Their efforts were well rewarded.

From early in the fourteenth century, a large fleet of galleys annually made the voyage from the Italian ports to the western Mediterranean and through the Strait of Gibraltar to the Low Countries. This voyage was publicly controlled. Space on the ships was auctioned to individual merchants, and goods were carried for their respective accounts. The ultimate destination of the voyage was usually Bruges in Flanders, which at that time was the great trading city of northwestern Europe. A part of the fleet frequently put in at London or Southampton. Spices, indigo, silks, wines, and raisins from the south were exchanged for metals, wool, hides, and (later) manufactures.

Hanseatic League.—The great expansion of production and trade in Europe during the Middle Ages stimulated the growth of towns. The trade of the towns, however, was handicapped by the large amount of piracy prevailing. In the North Sea, as elsewhere, pirates were numerous and were constantly preying upon shipping. Furthermore, according to the so-called Strand laws, if a ship were driven ashore, for whatever reason, it became the property of the owner of the coast. In order to reduce these and other hazards, the towns made agreements with one another, the aim being to promote trade. The towns formed

themselves into unions, the best known of these being the Hanseatic League, made up chiefly of German cities. The Hanseatic League was formed in the early fourteenth century and dominated the commercial and political life of northern Europe for nearly three centuries.

Embracing almost a hundred cities, including Cologne, Danzig, and Lubeck, the League was in reality a great commercial state. It had its own assembly, courts, treasury, fleets, and army. It waged war successfully against the King of Denmark and against England. It fought the pirates and made sea traffic much safer. Merchant ships, however, did not sail alone, but in fleets accompanied by vessels of war for protection.

A principal purpose of the League was to secure trade concessions from foreign rulers. The merchants of this period did not trade as individuals but as members of a certain merchant guild and from a certain town. They thus enjoyed the treaties made by the town, or group of towns. The privileges obtained by the Hanseatic League were extensive and were reserved exclusively for members. The League controlled nearly all the trade on the Baltic and North Seas. It established and controlled its own settlements and trade depots in London, Bruges, Bergen, and Novgorod. The merchants prospered, and as their wealth increased their status in society was raised. They became leading and influential members of the community. Their wealth permitted them to enjoy an education, and they assumed a position of importance alongside the clergy and nobility.

Several features of the modern capitalistic system developed in this period. As fortunes were amassed out of productive enterprises, wealthy families appeared, among them the famous Fugger family of Augsburg, Germany. Descended from an enterprising weaver who on his death in 1408 had left substantial savings, this family engaged in extensive financial and commercial operations during the fifteenth and sixteenth centuries. Under the leadership of the able Jacob Fugger, the family traded in spices, silk, and wool in nearly all the European countries. The Fuggers owned copper mines in Hungary and silver mines in the Tyrol. By 1500 they were the leading bankers in Europe, having acquired a huge fortune from which they

made large loans to the Pope and the Holy Roman Emperor. Their investments in Spanish shipping and colonization were particularly successful. By the middle of the sixteenth century, this family had built up a fortune of many millions of dollars.[2]

Europe Looks Westward.—During the fifteenth century developments occurred which shifted the center of trade from the Mediterranean to the Atlantic. The first of these was the capture of Constantinople by the Turks in 1453. This interfered with the well-established commerce between Europe, particularly the Italian cities, and the East. The goods which India and the East sent to Europe were of small bulk—silks, satins, perfumes, spices, and perhaps narcotics. These could travel over the long desert routes, but the goods of Europe were heavier and more cumbersome. Thus it was that the precious metals went from Europe to the East. Their increasing scarcity in Europe enhanced their value and led to a search for new sources of supply.

The result of these developments was active exploration, and the search for a new route to India began. Navigation had been stimulated by the traffic in slaves from Africa, as well as by the lure of the East and the vivid stories of returned traders. The Polo brothers, Venetian merchants, had visited Pekin and had been entertained by the Mongol emperor. Marco Polo, a son of one of the brothers, accompanied them on a second trip, and after his return to Venice in 1295, having been gone twenty years, amazed the people with his accounts of the Far East and of the gold of Japan.

Explorers ventured farther and farther. Cape Verde was reached in 1445, and the Cape of Good Hope in 1488 by Bartholomew Diaz. Diaz rounded the Cape but did not proceed to India. The route to India was discovered when Vasco da Gama, a Portuguese captain, made the complete journey to India in 1498 by way of the Cape of Good Hope.

[2] Carlton J. H. Hayes, *A Political and Cultural History of Modern Europe* (New York: The Macmillan Co., 1932), I, 89. See also H. Gordon Selfridge, *The Romance of Commerce* (London: John Lane, The Bodley Head, Ltd., 1923), chap. V, "The Fuggers of Augsburg."

In 1492, Christopher Columbus, seeking a route to India as well as gold, sailed westward under the flag of Spain and reached the Caribbean islands, which he believed to be just off the coast of Asia. About four years after Columbus' return, John Cabot sailed from England, via Iceland, and apparently reached the shores of Newfoundland. The earlier expeditions of the Norsemen had not resulted in the establishment of permanent trade routes or settlements, but they were nonetheless significant. In a few years it was found that these islands which Columbus had discovered, and the continent to the west were part of the "New World," which contained tremendous natural wealth. The gold which Columbus and other explorers brought back stimulated further adventure and discovery, with profound consequences. Soon the New World occupied the attention of Europe and poured in it vast amounts of precious metals.

In trading with the New World, the best-situated country was not Italy or the Baltic countries, but Britain. British supremacy in trade, however, was not attained easily nor until after a series of wars covering three centuries. These wars brought about the successive elimination of Portugal, Spain, Holland, and France as contenders for commercial supremacy.

Portuguese and Spanish Commercial Domination.—During the fifteenth century, Spain and Portugal were the leading sponsors of overseas exploration. Accordingly, in 1493 the Pope divided all new lands between these two countries. A "line of demarcation" was drawn from pole to pole 370 leagues west of the Azores. All new lands east of this line were conferred upon Portugal and all unexplored territory west of the line was granted to Spain. Thus Portugal secured Brazil and most of Africa and Asia, while Spain gained North America and most of South America.

For more than 50 years, Portugal engaged in an exceedingly profitable commerce with the coasts of Africa, India, and the East Indies. Portugal, however, small in size and with limited resources, was unable to prevent other European nations from encroaching upon its claims. The Netherlands, in particular, took advantage of Portugal's weakness. The Dutch

organized expeditions to Asia which openly attacked Portuguese vessels and which, through intrigue, aroused the opposition of native rulers to Portugal. Spain violated the papal treaty of 1493 by taking possession of the Philippine Islands, which were situated in the Portuguese hemisphere.

Upon the death of the last male heir of the Portuguese royal family in 1580, King Philip of Spain, the next in descent through a female line, became king of Portugal and annexed Portugal to Spain. The destruction of the Spanish Armada in 1588 by England definitely put an end to Portuguese commercial domination, since it led to the freedom of the Netherlands from Spain. The Dutch seized the Portuguese trading posts in Asia and Africa and in 1602 formed the Dutch East India Company. Only in Brazil did Portuguese control of any large area continue.

During the sixteenth century, Spain was the dominant European power. Spanish *conquistadores* plundered the rich Aztec and Incan treasures in the New World, and barbarously took possession of a large amount of territory. Spanish treasure fleets plowed back and forth between Europe and the New World, pouring into Europe huge quantities of the precious metals, particularly silver from the rich veins in Mexico, Bolivia, and Peru. Some of the metal was captured by British sea raiders, such as Francis Drake, Thomas Cavendish, Humphrey Gilbert, and Walter Raleigh. Little gold was brought back in the early period, but later the placer mines in Brazil were discovered and exploited. During the four centuries after Columbus, more than fourteen billion ounces of silver and one billion of gold were produced. As a result of the fabulous increase in the precious metals, the commodity price level rose sharply in Europe. Index numbers of prices rose from about 25 in 1500 to about 140 in 1600.[3]

Together with the gold and silver from the Americas came products which were entirely new to Europeans. Among the latter were such articles as cocoa, tobacco, maize, lima beans, potatoes, tapioca, and quinine. In exchange for these com-

[3] Carl Snyder, "The Problem of Monetary and Economic Stability," *Quarterly Journal of Economics*, Feb., 1935.

modities, Europe shipped wheat, hardware, gunpowder, cloth, and cheap trinkets for trade with the natives. The Europeans introduced many plants and animals into the New World, and before long there were supplies of these to be exported to Europe. In the West Indies, the manufacture of rum, made from fermented sugar cane, became a major industry.

The Spanish Empire remained largely intact until the beginning of the nineteenth century. Long before the empire finally collapsed, however, Spanish influence began to wane, the decline being due in large measure to the failure of Spain to put commerce and colonial development ahead of political exploitation. Colonial mismanagement, oppression, extravagance, and political intrigue eventually cost Spain her empire and her commanding position in world affairs. Spanish culture, however, was thoroughly implanted in the New World and continues strong there today.

Commercial Companies.—An interesting development in the conduct of commerce, following the discovery of the New World, was the appearance of the commercial company. The risks of long voyages and the capital outlay involved were often greater than one individual could undertake. Several persons therefore banded themselves together in a company for the purpose of pooling their resources and sharing the gains or losses. These commercial companies were chartered by the government and were usually very profitable. The wealth which accrued to the shareholders was considerable, so that the merchants grew rich. These companies were often given the exclusive right to trade with a particular area or colony and were sometimes charged with the responsibility of actually governing and defending the colony.

Some of the commercial companies, such as the British East India Company,[4] organized in 1600 under Queen Elizabeth for trade with India, were even more powerful than the Hanseatic League. The British East India Company ruled India until

[4] Holland, Denmark, Prussia, and Scotland also established East India companies. Most important of these was the Dutch East India Company, organized in 1602 and dissolved in 1798.

the Sepoy rebellion in 1857. It was believed necessary to give these companies such extensive privileges because they were assuming the risks of trading and were providing the large amounts of capital required. The privileges were often grossly abused by the companies, the foreign natives being ruthlessly exploited. The most powerful of the commercial companies were those of Britain. Among these were the Levant Company, the Virginia Company, an African Company, a Russian Company, and the Hudson's Bay Company. The last-named is still in existence.

One of the most notorious of these early companies was the South Sea Company, whose activities became known as the South Sea Bubble. The company was organized early in the eighteenth century (1711) to exploit the resources of South America, which had been partially opened to English traders by the Treaty of Utrecht. The public, expecting rich returns, scrambled to buy shares in the company. The managers of the company, elated by its popularity, offered the government a proposition wherein the company would take over the government debt on a 6 per cent basis, which was lower than the rates prevailing in the market. The offer was accepted, and the managers then endeavored to induce the holders of National Stock (government bonds) to exchange this for shares in the South Sea Company. According to this arrangement the government would then be paying the company the 6 per cent interest on the stock. The value of the company's shares given in exchange, however, was uncertain. The plan was successful, and the company issued large numbers of its shares in exchange for government stock.

Shares in the company were bid higher and higher, and shares formerly selling at £100 were sold at £1,300. Finally the public realized that the resources of South America were not unlimited and that so many shares had been sold that, when the profits were divided around, each shareholder would not receive very much of a return on his investment. The shares declined rapidly as everybody was eager to sell. The bubble burst, and the corruption was found to have involved government officials.

British Ascendance and Colonial Policy.—During the seventeenth and eighteenth centuries, commerce and war went hand in hand. The history of these years is to a large extent a contest of the nations for trade advantages, colonies, and imperial power. Commerce was regarded as the source of power, and colonies were considered to be the source of commerce. The Netherlands, which had succeeded Spain as the leading commercial nation, was forced in the latter part of the seventeenth century to capitulate to France and Britain. As a result of the Seven Years' War, ended in 1763 by the Treaty of Paris, England gained Canada and Nova Scotia from France, as well as several islands in the West Indies. England also retained her two forts controlling the Mediterranean—Gibraltar and Port Mahon on the island of Minorca. Britain was now the undisputed commercial leader.

The foreign colonies established by England were settlements made up of people who regarded the colony as their permanent home. On the other hand, according to the mercantilist philosophy then prevailing in Europe, colonies were considered as outlets for the sale of manufactures and as areas from which the mother country could receive raw materials. Colonial commerce was, therefore, extensively regulated in the interests of the mother country. Navigation laws and commercial companies were established so as to prevent trade of the colonies from being diverted to other countries. The colonies were thus not free to trade where they wished and in the manner they wished, but were exploited for the home country. England pushed this policy too far with her thirteen colonies on the Atlantic coast, with the result that she lost these valuable possessions. The American Revolution caused England to modify her colonial policy with respect to other possessions.

In the same year that the American colonies declared their independence from England, Adam Smith published his celebrated *Wealth of Nations,* which vigorously refuted the mercantilist philosophy. He preached the doctrine of laissez faire, and urged that the government leave trade unfettered to develop as it would. These doctrines of Adam Smith were widely accepted and very soon became the basis of governmental policy.

At the same time, there was beginning in England the Industrial Revolution. The Industrial Revolution completely changed the character of the goods entering into foreign commerce, with consequent profound effects upon the world's trade. The economies of large-scale production, made possible by the Industrial Revolution, led nations to specialize and to abandon self-sufficiency even in the production of necessities. The result was that necessities rather than luxuries soon made up the greater part of the goods of foreign commerce. Trade expanded rapidly, and huge quantities of goods, no longer merely spices and laces, but food, iron, and machinery, were moved long distances.

England became rapidly industrialized, turning out large quantities of manufactured articles. The industrialists in England desired cheap food for the workers, and during the 1840's the Corn Laws were repealed. This stimulated the importation of grain, and since the grain had to be paid for by exports, foreign commerce was further encouraged. The free trade policy of Great Britain, which permitted industries to develop extensively, and the country's consequent dependence upon foreign sources for food and other necessities greatly changed the character of Britain's entire economic life and improved the standard of living. This policy extended British commerce and was one of the main sources of British power.

Because of specialization and greatly increased production in all countries, the volume of world commerce has increased to an amazing degree since 1800. In this development Great Britain has played the leading role, and she has been the principal carrier of the world's trade. With her widespread colonial empire, industrialization and specialization at home, and a large fleet of ships, Great Britain is vitally dependent upon the flow of foreign commerce. Her naval policy was thus an accompaniment of commercial expansion. British ships have long been found all over the world, wherever ships venture.

The dominant position of Great Britain, however, has for some time been gradually weakening. The ravages of two wars have had a telling effect upon the British international position. These circumstances and the growth in the vast productive

power of the United States have caused the United States to move out in front.

The British Empire countries have been demanding, and receiving, more and more independence from the mother country. Today practically all the Empire enjoys complete autonomy. The Empire is now held together largely by sentiment and economic ties rather than by political authority. Britain has adapted herself to the changing situation, and even though most of the formal ties with the Empire have been broken, Britain's position has by this action been strengthened. Despite the ravages of war, the country's recuperative powers and inherent strength have been shown to be great and Britain remains a great commercial nation.

Chapter 3

FOREIGN TRADE OF THE UNITED STATES

Colonial Trade.—Prior to the discovery of America, Europe had a well-developed trade with the countries of the East, as noted in the previous chapter. As a result of large European purchases there, Europe had been drained of great quantities of the precious metals sent out in payment. The silks, gems, spices, and perfumes of the East were of small bulk and easily transported, whereas the manufactured and other products which Europe could offer in exchange were more difficult to carry long distances. Therefore, the precious metals were called upon as a means of making payment. Moreover, the virtual blocking of the established trade routes to the East by the activity of the Turks in Asia Minor in the fourteenth and fifteenth centuries interfered more greatly with European exports than with European imports. The net result was that the balance of trade was against Europe, and Europe lost bullion. The drain of bullion brought a declining price level in Europe, or a rise in the value of gold and silver, with depressing effects.[1] Increased production of commodities and the development of the towns also contributed to the demand for gold and silver and their rise in value.

Explorers who came to America were, therefore, interested in seeking new sources of gold and silver. The lands to the west were desired not so much for their fields, timber, and other resources as they were for the precious metals they were thought to contain. Exploration was to a large extent a quest for gold and silver, and it was the lure of these metals that attracted European adventurers. The newly discovered lands yielded

[1] Carl Snyder, "Gold, the Arbiter of Destiny," *Proceedings of the Institute of Finance,* Occidental College, Mar., 1931.

these metals in extremely bountiful supply. Little gold or silver, however, came in the early period from the territory which now comprises the United States. Silver came from the rich mines of Mexico, Peru, and Bolivia, and gold from Brazil. The region which constitutes the United States supplied Europe, however, with important quantities of crude raw materials and with several entirely new products.

Tobacco, previously unknown in Europe, was one of the principal articles of export from North America during the Colonial period. It accounted for about one-fourth to one-half of all the exports sent out. The systematic cultivation of tobacco began early in the seventeenth century in Virginia, and by 1700 annual exports of tobacco amounted to about 29,000,000 pounds. By the time of the American Revolution these exports had increased to about 85,000,000 pounds with a value of about $4,000,000.[2]

Another product exported during the early period was lumber. The iron industry in England had created a strong demand for charcoal, with the result that England's forests were rapidly being depleted. The abundant timber in the American colonies provided England and other countries with a plentiful supply of lumber. Trees which could be used for masts for ships were especially in demand. The lumber came mostly from the northern colonies, since those in the south were more interested in tobacco.

With the principal materials for shipbuilding close at hand, the shipbuilding industry began to thrive in America early in the seventeenth century. Ships were built not only for domestic use but also for sale to foreign countries, so that ships became an important article of export. It is said that at the time of the Revolution one-third of the ships under the British flag had been built in America. The pre-eminence of America in shipping and in seafaring occupations continued until the Civil War, when iron steamships replaced the old wooden sailing vessels. Other exports during the Colonial period having to do with shipping were tar, pitch, rosin, and turpentine.

[2] E. L. Bogart, *Economic History of the United States* (New York: Longmans, Green & Co., 1930).

The virgin country of North America also yielded large quantities of furs and skins which were exported to the European countries in exchange for much-needed manufactured goods and other articles. Fishing developed early in North America and provided an important export. The fishing resources of the New England coast had been exploited by the British some time before regular settlements were established there. When settlements began to spring up, therefore, the fishing industry developed rapidly and became an important source of income to the New England colonies. Cod and mackerel were the principal fish exported.

While a few manufactured articles were exported, such as leather goods, the colonies were importers rather than exporters of finished products. Few industries had been developed, so that the colonies were dependent upon England and the Continent for a large portion of their manufactured goods such as cloth, paper, iron, and iron products. The foreign trade of the colonies was principally with Great Britain and with the French and Spanish Indies.

Trade between the Old World and the New, it will be seen, involved principally the giving of crude and raw materials or agricultural products in exchange for manufactured articles. In order to encourage the growth of domestic industries, most of the colonies had subsidies and tariffs, many of which, however, were directed not against foreign nations, but against competing colonies.

American Trade and the Revolutionary War.—England, like the other countries of Europe, regarded her colonies largely as possessions to be used for her own benefit—a source of raw materials and a market for her finished goods. In order to give effect to this policy, England placed various restrictions upon the trade of the colonies. She granted monopolies, levied duties, and endeavored to prevent the growth of industries in America. The Navigation Acts of 1651 and 1660-63 provided that no goods could be transported to or from British colonies except in British ships; they forbade the colonies from buying and selling directly in Europe and other foreign markets, and placed

other handicaps upon American trade and industry. Until the end of the Seven Years' War in 1763, however, the restrictions of Great Britain had not been taken very seriously in America. They were either not enforced or were to a large extent evaded, so that American trade and manufacturing forged ahead.

After the Seven Years' War, however, when the trade of the colonies, both domestic and foreign, was expanding rapidly, Great Britain undertook to enforce more rigidly her restrictive policies. The colonists protested vigorously and organized boycotts against British goods. Importations from Great Britain were finally reduced to such an extent that British mills had to close down. The conflict between Britain and the American colonies regarding commerce was one of the principal factors leading to the Revolutionary War and the independence of America.

During the Revolutionary War the foreign trade of the colonies was almost completely cut off. After the war, imports poured into America in such volume that many of the new industries, which had grown up during the war when foreign goods were unavailable, could not meet the foreign competition and found it necessary to shut down. Great Britain, moreover, enacted various laws which injured the American export trade. She practically excluded American ships from the West Indies, and she insisted that exports to Great Britain could come in American ships only when the exports came from the same state in which the ship was owned. The export trade of the United States thus was not booming, nor was this country having much success in consummating commercial treaties with the various European governments.

Under the Articles of Confederation, Congress was powerless to enact retaliatory measures or to undertake to regulate commerce. The different states, therefore, adopted their own tariffs and other measures, which in many instances were directed at each other, as in the Colonial days. This situation was remedied when the Constitution, which went into effect in 1789, gave Congress authority "to regulate commerce with foreign nations" and to levy duties. These powers were taken from the

states by the Constitution and lodged with the federal government. They may not be exercised by the states except with the consent of Congress.

Trade During the Napoleonic Wars.—Changed conditions in Europe, principally the outbreak of the French Revolution in 1789 and the Napoleonic wars soon thereafter, had important repercussions in America. The effect upon this country's shipping and foreign trade was particularly noteworthy. The United States remained neutral in the long struggle between France and Great Britain, to the great displeasure of France, which had aided American independence. While Europe was occupied with wars and was neglecting foreign commerce, the foreign trade of the United States grew by leaps and bounds. The belligerent countries were in great need of American commodities, particularly food products such as wheat, corn, and meat, so that exports from this country were large. Wool, cotton, and other raw materials were also in great demand. American agriculture boomed as the prices of these articles rose higher and higher. Land values increased, and new land was cleared for cultivation. Exports of cotton, largely as a result of the invention of the cotton gin, increased from 200,000 pounds in 1791 to over 50,000,000 pounds in 1804.

French shipping virtually disappeared during the wars. British shipping was concerned primarily with the prosecution of the wars, so that American ships were enabled to do a very large amount of the world's carrying trade, particularly that formerly done by France and her allies. Much of the trade between Latin America, the West Indies, and Europe was conducted by way of the United States, where new papers were taken out, so as to remove some of the risks of the trade becoming the prey of British ships. In the year 1801 more than half of American exports were re-exports.[3] American ships also carried goods from the Far East to Europe.

Due principally to the stimulus of the Napoleonic wars, the tonnage of American ships on the high seas increased sixfold

[3] Bogart, *op. cit.*

in the fifteen years following the adoption of the Constitution. Earnings of American ships during this period were accordingly large.

The situation changed suddenly, and beginning about 1804 American foreign trade experienced an about-face. Both France and Great Britain had become jealous and uneasy over the expanding trade of the United States, a neutral. While the European nations fought, the United States was running off with the prize. These countries consequently enacted measures aimed to restrict the prosperous American trade. In 1804 England declared a blockade of certain French ports and made any vessel trading with these ports subject to capture. The blockade was extended until in 1807 it included all the ports of France, her colonies, and her allies. Neutral vessels, by these Orders in Council, were forbidden to trade with any country under Napoleon's control. The territory involved included all Europe except Turkey and Scandinavia.

In 1806 and 1807, Napoleon for his part declared that the Continent was entirely closed to British goods and that any ship that traded with Great Britain or her colonies, or that obeyed the British orders, was subject to capture. Thus any neutral vessel that touched at a British port was likely to be seized by France, and any such vessel that did not touch there was likely to be seized by Great Britain. If American ships traded with France or her allies, they were subject to British capture; whereas, if they traded with Britain or her allies, they were subject to French capture. There was little territory left. As a matter of fact, there was a great deal of illicit trade as a result of corruption on the part of French, British, and other persons. These restrictive measures were aimed particularly at America. They succeeded in practically ruining American trade, so that about 1806 the rapid growth of American commerce came to an end.

The long-standing friction between the United States and Great Britain was intensified by British preying on American commerce and by the British practice of stopping American ships and taking off sailors who Great Britain claimed were British and were needed in the wars. America objected

strenuously to this practice, and feeling ran high. Since America had almost no navy, she endeavored to retaliate by the Embargo Act of 1807, which prohibited American vessels from leaving America for foreign ports. The purpose of this Act was to starve Europe into giving America better treatment and to prevent ships from being captured. The effect on America, however, was disastrous. Consequently, in 1809 the Non-Intercourse Act was substituted. This permitted trade with all countries except France and Great Britain. Finally, in 1812, the United States took the bold step of declaring war on Great Britain, although sentiment in this country was strongly divided on the matter. Certain elements in the South and West desired to conquer Florida and to annex Canada, and this was a contributing factor.

Trade After the War of 1812.—With the defeat of Napoleon and the opening of Europe to British trade in 1813 and 1814, most of the causes of the trouble between the United States and Great Britain were automatically removed. By the Treaty of Ghent, in December, 1814, peace between the two English-speaking nations was re-established. Contrary to expectations, the United States had been successful in the contest on the sea, but not in that on land.

When the war was over, the foreign trade of the United States expanded greatly, as is ordinarily the case following a war. Demands pent up during the war were released, and shipping was resumed. An enormous cotton crop was harvested in 1815, which helped to swell exports. Currency inflation and reckless speculation took place, resulting in a high level of commodity prices, large profits, and temporary prosperity. Shipping enjoyed its share of the prevalent prosperity.

Importations of goods from abroad were tremendous in 1814, 1815, and 1816. Foreign goods literally flooded the country, and, although this damaged American manufactures and brought an end to the few months of special activity that manufacturers had enjoyed immediately following the war, the popular view at the time was that the huge imports represented great business development and prosperity.

The demand for protection against the inundation of foreign goods was strong after the boom came to an end in 1815. Foreign nations had begun to enact commercial restrictions which handicapped American trade, and sentiment developed in America that this country should also apply restrictions against foreign goods. In 1815 Great Britain raised the duty upon grain imports so high that American grain was almost completely excluded from the British market. Congress, therefore, in 1816 enacted a protective tariff which imposed a duty of about 20 per cent upon foreign textiles and various duties on other goods.

The boom ended in 1815, and from 1816 until about 1821 the United States was in a depression which became especially severe in 1819. The heavy influx of foreign goods was checked by the depression and also by the new tariff adopted in 1816. Furthermore, lower prices of commodities reduced the values of the goods imported. Imports accordingly fell from about $147,000,000 in 1816 to about $74,000,000 in 1820. The sharp decline which foreign trade suffered was the beginning of a period of declining or stationary foreign trade for the United States lasting until about 1830.

The large volume of trade from 1789 until 1818 had been based chiefly upon the wars and troubles of Europe. As Europe returned to peaceful pursuits and production there increased, American goods and ships were in less demand. The period following the Napoleonic wars was marked by general economic troubles throughout the world and by the enactment by most countries of tariffs and other restrictions upon trade, a situation somewhat similar to that following the two World Wars. With foreign trade no longer prospering, the United States turned its attention to domestic affairs and to the development of its own industries and vast resources. The United States now looked more to the undeveloped West than to the East.

After 1830 and until about 1850 the foreign trade of the United States was again growing, but growing rather slowly. Imports fluctuated more widely than did exports, reflecting fluctuations in the national income of the United States greater than those of most other countries. Foreign trade, especially

the import trade, was active in 1836 during the speculative boom which collapsed in 1837 and which centered around land. Foreign trade declined after the boom.

FIG. 1.—United States Foreign Trade Since 1850

About 1850 both imports and exports began to expand rapidly and continued to do so until the outbreak of the Civil War. Most of the increase in exports during this period was accounted for by the development of cotton cultivation in the South and the growth of the textile industry abroad. With cotton constituting more than half of the country's exports, about two-thirds of all exports came from the South. New Orleans ranked as a port next to New York. The North was concerning itself

more with manufacturing, while the South was enjoying agricultural expansion.

Trade from 1860 to 1914.—Foreign trade received a severe setback during the Civil War, as can be seen in the accompanying chart (Figure 1) which shows America's foreign trade since 1850. The trade of the southern states was particularly hard hit and came almost to a standstill. In 1861 the federal government proclaimed a blockade of all ports of the southern states. Although the blockade could not be enforced immediately, soon the federal government had either captured or effectively closed all the principal southern ports. Blockade runners, especially British vessels, managed to land goods and pick up cargoes, although the business was hazardous. Cotton exports declined from about $200,000,000 in 1860 to about $4,000,000 in 1863. It was said that by 1864 a pound of cotton could be bought for four cents in Charleston while in Liverpool its cost was $2.50. The closing of the market for the South's great product, cotton, was a serious blow to the South and one of the deciding factors in the war.

After the war, foreign markets again received attention. The United States went through eight years of intense business activity and boom culminating in 1873. During this period foreign trade, especially imports, enjoyed phenomenal increases. Total foreign trade increased from $405,000,000 in 1865 to $1,164,000,000 in 1873.

During the post-Civil War period the opening of the agricultural lands in the Middle West had important effects upon foreign trade. Even during the time the war was being fought, the North developed its agricultural resources and introduced improved machinery which greatly increased agricultural output, particularly grain. The country's population moved westward into the Mississippi Valley during and after the war and opened up extensive tracts of land. Immigration from Europe was large, and many of the immigrants settled in the grain-producing states where land was plentiful. Railroads were extended rapidly, too rapidly from the profit standpoint, and were pushed into new and undeveloped territory. Extensive railroad construction meant cheap transportation from the agri-

cultural sections to the seaboard, whence products could move easily to foreign countries.

As a result of these developments, agricultural products of the Middle West began about 1870 to constitute an increasingly important element in the nation's total exports. Between 1870 and 1880 total exports more than doubled, due in large part to increases in exports of grain and breadstuffs.

The variety of goods exported also increased during the latter part of the century, so that whereas in 1860 the first six items of exports accounted for over 90 per cent of all exports, by 1900 the first six items accounted for only about 65 per cent of all exports.

One of the effects of the Civil War was the almost complete disappearance of American ships from the high seas. During the war most of the ships were destroyed by Confederate cruisers, were converted into war vessels, or were sold to foreigners. After the war the United States would not permit vessels that had been sold to foreigners to fly again the American flag. Another blow to the merchant marine was the high duties upon shipbuilding materials, iron, steel, copper, lumber, and cordage. American shipbuilders were thus unable to compete successfully with foreigners. One of the fundamental causes, however, for the decay of the American merchant marine was the passing of the old wooden ship and the picturesque sailing vessel. In the construction of such ships the United States was especially favored. American seamen also knew how to handle these ships. The United States was not so well prepared to build and operate iron and steel vessels propelled by steam as were England and other foreign countries.

When the first World War broke out in 1914, the United States found herself almost completely dependent upon ships of other nations. As these ships were withdrawn or used for war purposes, American trade was handicapped. American troops were carried to Europe in ships of Great Britain, France, and Italy, and in the seized ships of Germany. Prior to the second World War the United States endeavored to build up American shipping through subsidies of various kinds. In this effort she attained moderate success, although the tonnage of available

ships was inadequate for the huge task. This program is discussed in Chapter 37.

The year 1874 was noteworthy in that the balance of merchandise trade of the country shifted that year from an excess of merchandise imports, which had existed more or less regularly as far back as records go, to an excess of merchandise exports. Since 1874 the United States has, with two exceptions (1888 and 1889), continuously had an annual excess of merchandise exports.

The explanation of this shift to a so-called favorable balance has to do principally with the development of the country by foreign capital. New capital had come to America from Europe in large amounts, and this tended to increase imports. Prior to about 1874, the influx of new capital, together with shipping services rendered by the United States and other transactions involving payments to this country, were in excess of interest payments which this country had to make abroad and other items involving payments by the United States. In 1873 the United States experienced a severe financial panic, followed by prolonged depression and a decline in imports. The boom preceding the panic had centered around speculation in railroad securities accompanying rapid railroad expansion, financed to a considerable extent by European capital. With the panic, activity and capital receipts slowed down. After 1874 interest payments due by the United States were larger than the new capital received, and exports exceeded imports.

About 1900 another period of rapid expansion of America's foreign trade began. It continued to the beginning of the first World War, when still greater expansion took place. The stimulus to trade following 1900 was the extensive development of large-scale manufacturing industries and the marked improvement in transportation facilities on both land and sea. The United States, by this time, had become a great industrial nation with huge factories pouring out quantities of goods. Although the United States was an industrial nation, it was, and still is, also an agricultural nation. The change in the character of the foreign trade of the United States during the country's history can be seen in Table 1, on page 46.

Trade from 1914 to 1929.—When war broke out in 1914, the foreign trade of practically the entire world became disorganized. Shipping was disrupted, and much of it became the prey of enemy vessels. Peacetime cargoes gave way to wartime necessities as the productive equipment of all nations, particularly of the belligerents, was directed to war purposes. Products of the neutral nations were in great demand, and exports from the United States rose abruptly from $2,400,000,000 in 1914 to $6,300,000,000 in 1917. Imports into the United States declined slightly during the first two years of the war, but in 1916 imports were larger than ever before. The increase in imports, as would be supposed, was relatively less than that of exports, inasmuch as European production was handicapped by war. Part of the increase of both exports and imports was due to the high level of commodity prices that prevailed, rather than to greater quantities shipped.

After the United States joined the war in 1917, this country continued to supply Europe with large quantities of goods of all kinds, so that exports remained large. The principal exports were foodstuffs, iron and steel, and textiles. A country cannot fight and still produce as usual, so that in 1918 exports were a little less than in 1917, even though commodity prices were higher. The large exports of the United States during the war period were financed to a great extent by loans, most of which were not repaid. During the second World War, exports to this country's allies were financed by lend-lease, no attempt to receive payment being made.

The greatest increase in America's foreign trade came in the two years following the first war, 1919 and 1920. The tremendous increase was caused by the release of demands pent up during the war, by the restoration of ships to their former routes, and by the further inflation of commodity prices which made part of the increase more apparent than real.

During the war, ships had been busy carrying troops and necessary war supplies. Upon the signing of the Armistice, the submarine danger was removed and vessels were free to go where they chose. Neutral nations, made prosperous by the war, and nations formerly belligerent were enabled to pur-

chase many articles that had been unavailable. In 1920 exports and imports of the United States both reached the highest points in dollar values they had ever reached. Exports mounted to $8,228,000,000 and imports to $5,278,000,000. The continuation of inflation in practically all countries, resulting in soaring commodity prices and incomes, and the seemingly unlimited demand for certain commodities, brought great prosperity and boom, prosperity of an unstable type, but prosperity in which foreign trade shared generously.

Foreign countries, particularly those of Latin America, bought heavily in the United States immediately after the war. The orders came pouring in so fast that American factories were unable to meet the demands. The American manufacturers accordingly began to scale down the orders before filling them. Foreign purchasers, finding their orders reduced, countered by ordering more than they wanted. Price was of little importance, since the goods could easily be sold at a profit. When the bubble burst in 1920, American producers attempted to fill the orders in full, and foreign purchasers replied by wholesale cancellations of orders. The losses on both sides were severe.

The depression of 1920-21, disastrous to many undertakings, was especially disastrous to foreign trade. Both exports and imports of the United States declined in 1922 to less than half their 1920 high points. As the world recovered from the depression and the effects of war, the world's production became organized upon a peacetime basis and foreign trade resumed its upward climb. The United States found then that it had to meet the competition of European nations, competition which had been almost wholly absent since 1914. Although the United States lost some of the newly gained markets, chiefly in Latin America and the Orient, to the countries which originally served them, the United States came out of the war a leading nation in the field of international commerce and finance.

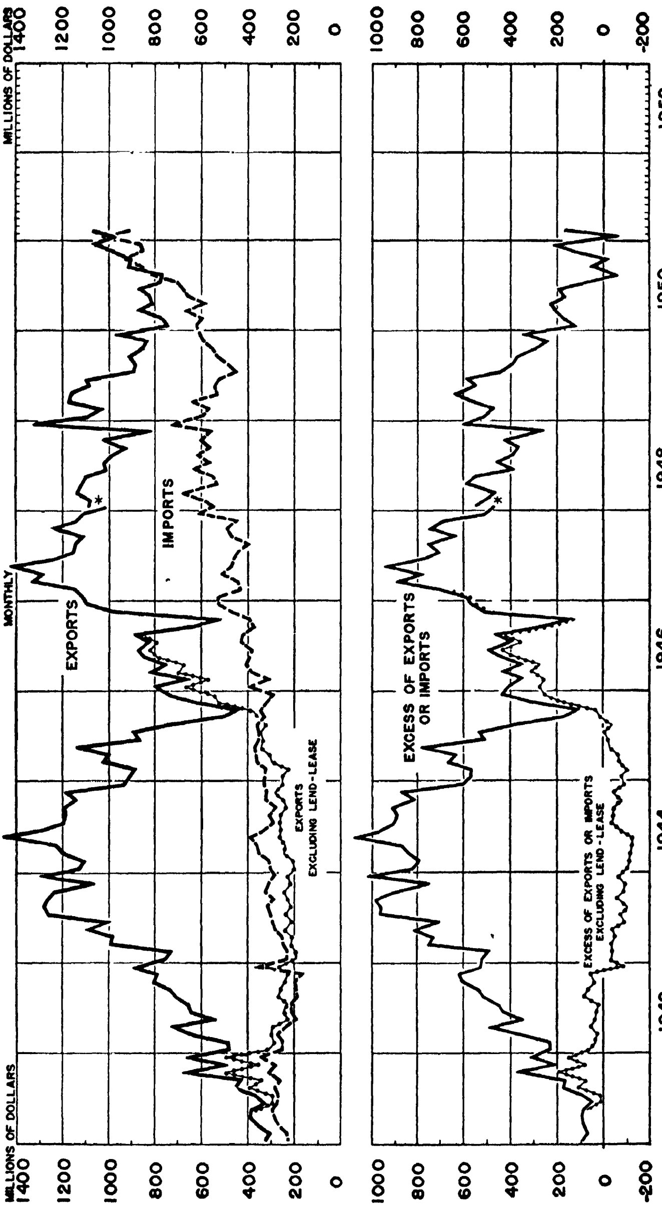
Trade Since 1929.—The prosperity and boom of the 1920's, which ended in 1929, were reflected in active foreign commerce. By 1929 the trade of the United States had recovered so that

exports amounted to $5,241,000,000 and imports to $4,400,000,000.[4] The severe and prolonged depression which began in that year brought with it a decline in the country's foreign commerce more serious than that of 1920-21. In the year 1932 exports amounted to only $1,612,000,000 and imports to only $1,323,000,000. Exports were thus only about 29 per cent of the 1929 figure and imports about 30 per cent. This decline was greater than that of other leading nations, for which the 1932 trade was, on the average, about 38 per cent of the 1929 trade. Inasmuch as the commodity price level fell by about one-third, the decline in volume was not as great as that in the value of the goods. The effect of the drastic decline of foreign trade upon United States industries and upon the agricultural population, dependent upon the foreign market, was severe.

The decline was aggravated by the high tariffs adopted by the United States and other nations and by various other restrictive devices put into force. The United States, a large creditor on capital account, made the payment of interest to it difficult by its high tariff policy, which discouraged imports. This policy was also one of the causes of the heavy gold importations. The large merchandise exports of the United States during the 1920's were financed to a considerable extent by loans, rather than being paid for by imports. Foreign bonds were sold in the United States, and the proceeds, which were made available to foreigners, were used to buy American goods. The export trade was thus sustained by loans, particularly by the numerous foreign bond issues floated in the United States. Some of these bonds subsequently went into default as the depression deepened.

As depression gradually gave way to recovery, foreign trade began in 1933 to regain much of the ground it had lost. All over the world trade again increased, but the improvement as far as Europe was concerned was cut short by the outbreak of war in 1939. The foreign trade of the United States, however, was expanded by the war, and in 1941 exports were approxi-

[4] Unless otherwise indicated, reference is made throughout only to the merchandise trade, and not to invisible items.



Latest figures plotted: February.
* Beginning January 1948, includes shipments of civilian supplies for army distribution in occupied areas.

FIG. 2.—United States Foreign Trade Since 1940
(Source: Board of Governors of the Federal Reserve System.)

mately at their 1929 level. Imports, however, remained low, since Europe was unable to export as usual.

After the inauguration of lend-lease arrangements in 1941 and especially after the United States became a belligerent late that year, exports increased considerably and reached a new peak in 1944. The great bulk of exports during the war went out under lend-lease arrangements, since the recipient countries had inadequate resources to make payment. Imports increased somewhat, but during the entire war remained below predepression levels. Imports from Latin America, however, were stimulated by the shutting-off of other sources of supply and by the need of the United States for Latin American raw materials.

The postwar readjustment of 1945 and 1946 resulted in a sharp reduction in exports but not in imports, which rose considerably as foreign goods again became available. In 1947, however, exports expanded greatly and reached the highest level they had ever attained, $15,340,000,000. These postwar exports were paid for to a large extent by the United States government in the form of grants or loans to aid reconstruction. As European production recovered and as the rest of the world became less dependent upon the United States, exports declined, but imports increased and continued to reach new high levels, also reflecting recovery abroad.

After the invasion of Korea in 1950 and accompanying the rearmament program, the expansion in United States imports, particularly raw material imports, was accelerated. The prices of raw materials rose sharply thus increasing import values. Exports and imports were in approximate balance at the end of 1950. Figure 2 shows this country's foreign trade since 1940.

Character and Direction of Trade.—The United States has gradually changed from an exporter of raw and crude materials, and an importer of finished manufactured articles, to an importer of raw materials and an exporter of finished products. This shift in the character of the trade reflects the industrial development of the country, and may be seen from the figures in Table 1 (page 46).

TABLE 1

CHANGES IN CHARACTER OF UNITED STATES FOREIGN MERCHANDISE TRADE

(Per cent of total)

	Imports					Domestic Exports				
	1820	1860	1929	1939	1950	1820	1860	1929	1939	1950
Crude materials	4	11	35	33	28.2	61	68	22	17	18.6
Foodstuffs	31	30	22	27	30.3	29	16	14	10	13.4
Semimanufactures	8	10	20	21	24.3	9	4	14	20	11.1
Finished manufactures	57	49	23	19	17.2	6	11	49	53	56.9
Total trade (millions of dollars)	$74	$354	$4,400	$2,318	$8,735	$70	$334	$5,241	$3,178	$10,142

(Source: U.S. Department of Commerce.)

The United States, with its extensive and varied resources and technological advancement, has developed an economy

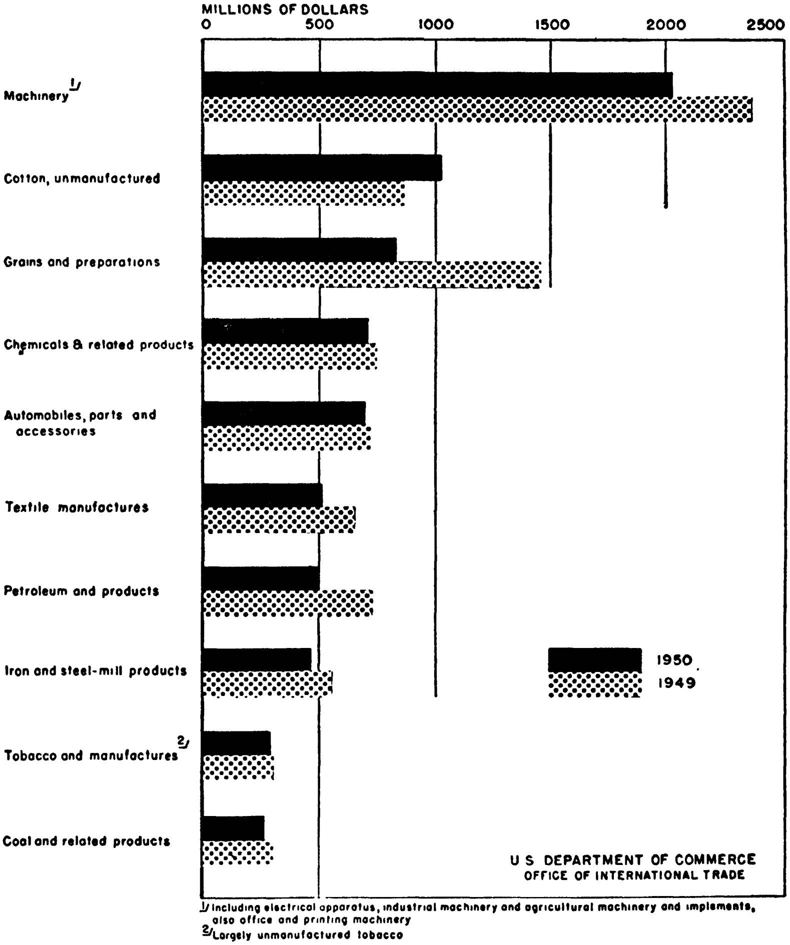


FIG. 3.—United States Leading Exports, 1949-50.

wherein the production of the different types of goods is well diversified. The United States today produces most of the crude materials, food supplies, and finished products which it consumes. It is both an agricultural and an industrial na-

tion. While United States foreign trade has over the years increased greatly in volume, this trade has shown a tendency to represent a declining percentage of the national income. Al-

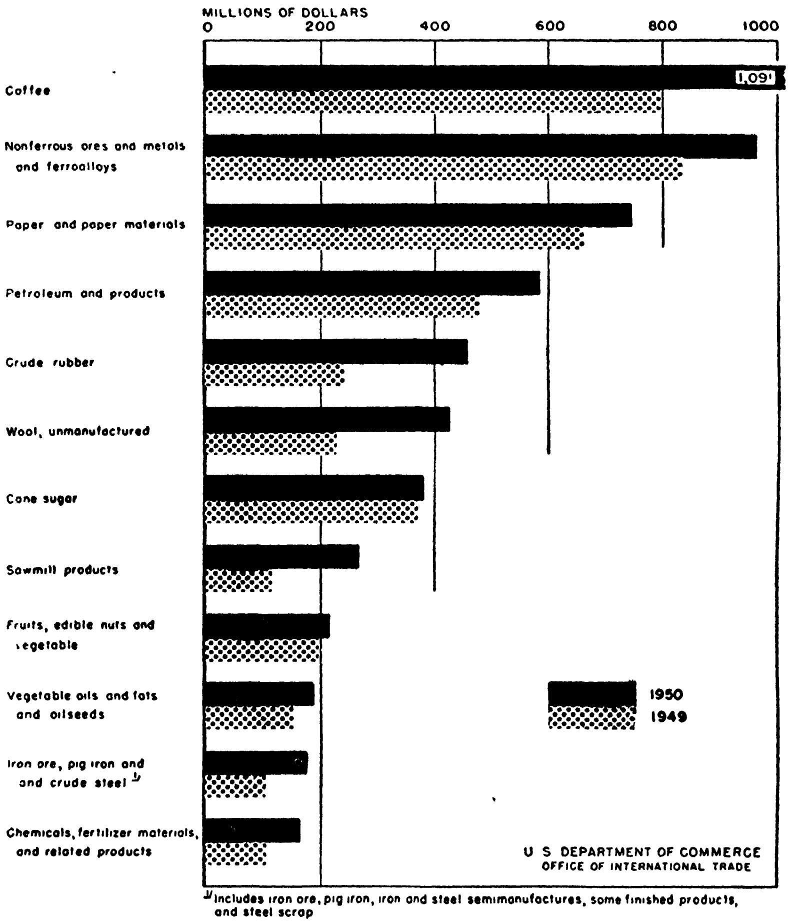


FIG. 4.—United States Leading Imports, 1949-50

though United States production is more diversified and in better balance than that of other countries, the United States is of course far from being self-sufficient. To the extent that greater self-sufficiency in any country is forced and does not

result from the free play of economic forces, it is generally wasteful and uneconomic, although in some cases it is desirable for security reasons.

Accompanying the trend in the United States of increasingly heavy imports of crude materials, supplementing domestic production of such materials, there has been taking place a worldwide increase in the share of trade represented by crude materials. As foreign countries have become industrialized, manufactured articles have represented a smaller percentage of total world trade and crude materials a larger percentage.

The principal commodities exported and imported by the United States are shown in order of value in Tables 2 and 3 (pages 50-53) and graphically in Figures 3 and 4 (pages 47-48). Most of the crude materials and foodstuffs that are exported, especially cotton and grain, go to Europe. As a consequence of the large percentage of agricultural exports, this country's exports to Europe have usually shown a seasonal expansion in the fall and early winter. Asia also takes a considerable amount of American farm products, cotton, and tobacco, so that exports to Asia exhibit seasonal increases in the fall. Imports into this country do not show the pronounced seasonal movements that do exports, but they tend to be largest in the early part of the year.

Inasmuch as manufactured articles constitute the smaller portion of United States imports and crude materials the larger portion, the source of United States imports has become increasingly the non-European world. Latin America, Canada, and the Far East now supply this country with the bulk of its imports. Table 4 (pages 54-55) shows the principal countries with which the United States trades.

The total foreign commerce of the United States since 1800 is shown in Table 5 (page 56). Figures before 1821 are not very reliable, inasmuch as prior to that date imports that were not dutiable were not recorded, and such imports as were subject to a specific duty were recorded only by quantities, not values. In 1835, the Treasury Department compiled figures for the early period, basing many of the figures upon estimates and such data as were available.

TABLE 2

UNITED STATES EXPORTS OF LEADING COMMODITIES

Commodities in each class are listed in order of value in 1950.

Commodity	Quantity				Value (in millions of dollars)			
	1947 *	1948	1949	1950	1947 *	1948	1949	1950
Crude materials:								
Cotton, unmanufactured .... thous. bales	2,791	3,057	5,373	5,899	427	511	874	1,024
Coal .... thous. short tons	77,279	52,606	32,785	29,360	620	479	297	269
Tobacco, unmanufactured .... mil. lb.	507	427	498	476	271	215	252	250
Crude petroleum .... thous. bbl.	46,356	39,737	33,068	34,824	99	117	98	103
Foodstuffs:								
Grains and preparations	–	–	–	–	1,866	1,705	1,457	834
Wheat, including flour .... mil. bu.	502	508	416	252	1,294	1,393	1,002	489
Fruits and vegetables	–	–	–	–	366	283	189	171
Meats and edible animal fats .... mil. lb.	878	461	799	610	258	128	144	107
Dairy products and eggs	–	–	–	–	368	256	200	103
Manufactures, including semimanufactures:								
Machinery †	–	–	–	–	2,405	2,307	‡ 2,331	‡ 1,978
Electrical apparatus	–	–	–	–	582	516	‡ 452	‡ 393
Industrial machinery	–	–	–	–	1,371	1,277	‡1,322	‡ 1,102
Agricultural implements	–	–	–	–	96	114	128	109
Tractors, including parts and accessories §	–	–	–	–	222	268	‡ 299	‡ 245
Tracklaying tractors, new .... number	12,124	11,686	‡ 16,528	‡ 13,897	56	55	‡ 78	‡ 66
Wheel tractors, new .... do.	80,999	102,435	99,279	75,977	84	127	133	103
Chemicals and related products	–	–	–	–	858	787	‡ 749	‡ 711
Medicinal and pharmaceutical preparations	–	–	–	–	183	193	198	212
Chemical specialties	–	–	–	–	157	157	‡ 165	‡ 179
Industrial chemicals	–	–	–	–	162	140	117	‡ 96
Automobiles, including parts and accessories ‖	–	–	–	–	1,103	898	‡ 730	‡ 703
Passenger automobiles, new .... thous.	268	208	140	120	337	281	206	179
Motor trucks and busses, new .... do.	268	206	‡ 135	‡ 131	431	348	‡ 229	‡ 217

	1947 *	1948	1949	1950	1947 *	1948	1949	1950
Textiles and textile manufactures §§	-	-	-	-	1,418	844	656	516
Cotton cloth, duck and tire fabric... mil. sq. yd.	1,480	939	880	559	528	314	224	149
Woven fabrics of synthetic fiber** ... do.	248	208	251	180	175	132	120	85
Iron and steel-mill products:								
Total, including scrap ... thous. s. tons	6,961	4,801	5,337	3,294	825	650	732	473
Total, excluding scrap ... do.	6,791	4,589	5,039	3,076	820	642	725	467
Petroleum products ...	-	-	-	-	542	540	463	397
Motor fuel and gasoline ... thous. bbl.	36,851	27,163	28,410	16,908	135	134	146	90
Lubricating oils ... do.	14,064	13,546	12,318	13,616	195	199	169	174
Advanced manufactures of iron and steel ...	-	-	-	-	261	207	184	150
Merchant vessels ... number	1,838	819	436	300	625	255	173	118

NOTE.—Data include civilian supplies sent to occupied areas by United States armed forces. All figures have been adjusted to conform as nearly as possible to the 1949 schedule B classification of commodities.

* High postwar year.

† Includes electrical apparatus, industrial machinery, office appliances, printing machinery and agricultural implements and tractors.

‡ Data exclude special category exports.

§ Data include used tractors.

‖ Excludes service equipment.

§§ Includes finished products and yarns and other semimanufactures.

** Excludes pile fabrics and upholstery and drapery fabrics.

(Source: Department of Commerce.)

TABLE 3

United States Imports for Consumption of Leading Commodities

Commodities in each group are listed in order of value in 1950.

Commodity	Quantity 1947	Quantity 1948 *	Quantity 1949	Quantity 1950	Value (in millions of dollars) 1947	Value 1948 *	Value 1949	Value 1950
Crude materials:								
Crude rubber . . . mil. lb.	1,587	1,646	1,480	1,800	317	309	240	459
Wool, unmanufactured . . . mil. lb. †	644	761	441	730	209	308	222	427
Crude petroleum . . . thous. bbl.	99,284	128,557	154,719	172,736	162	283	341	367
Nonferrous ores and concentrates ‡ . . .	–	–	–	–	173	216	265	243
Hides and skins . . . mil. lb.	179	252	169	312	86	108	73	118
Oilseeds . . . do.	1,702	1,364	1,264	1,281	139	151	95	118
Copra . . . do.	1,355	898	856	933	107	110	69	105
Flaxseed . . . do.	16	60	8	§	2	6	1	82
Undressed furs . . .	–	–	–	–	122	159	103	§
Vegetable fibers, except cotton, unmanufactured . . . thous. long tons	271	270	249	313	81	93	88	101
Sisal and henequen . . . do.	117	114	126	153	32	35	36	95
Diamonds, rough or uncut and industrial . . . thous. carats	5,113	11,558	7,014	11,785	56	78	46	39
Tobacco, unmanufactured . . . mil. lb.	90	84	88	90	91	78	73	80
								76
Foodstuffs:								
Coffee . . . do.	2,499	2,774	2,923	2,439	601	698	795	1,091
Cane sugar . . . do.	8,330	6,402	7,457	7,349	411	313	372	380
Fruits, edible nuts, and vegetables . . .	–	–	–	–	189	222	199	215
Cocoa, or cacao beans . . . mil. lb.	599	547	632	670	152	194	125	167
Fish, including shellfish . . . mil. lb.	407	472	469	638	83	111	112	157
Meat products . . . mil. lb.	57	263	212	280	23	91	72	113
Alcoholic spirits and wines . . . thous. gal.	8,296	10,094	10,484	13,549	64	83	87	113
Grains and preparations . . .	–	–	–	–	7	29	75	78
Semimanufactures:								
Nonferrous metals . . .	–	–	–	–	368	562	571	724
Copper ‖ . . . mil. lb. §§	301	500	553	644	60	107	111	130
Tin ** . . . mil. lb.	56	112	136	191	43	104	134	155
Lead †† . . . mil. lb. ‡‡	349	547	573	914	41	89	84	108
Sawmill products, except railroad ties, sugar-box shooks, and packing boxes . . . mil. bd. ft.	1,305	1,869	1,563	3,423	101	151	112	264

	1947	1948 *	1949	1950	1947	1948 *	1949	1950
Wood pulp . ...thous. s. tons	2,322	2,176	1,763	2,379	256	272	182	240
Gas oil and fuel oil... ....mil. bbl.	63	59	80	125	85	126	127	204
Steel-mill products	–	–	–	–	9	43	66	131
Vegetable oils and fats, expressed.......... mil. lb.	383	379	328	441	109	84	61	85
Diamonds, gems, cut but unset ....thous. carats	348	389	335	493	53	56	41	59
Finished manufactures:								
Paper and manufactures	–	–	–	–	363	438	453	473
Newsprint ....mil. lb.	7,916	8,791	9,279	9,726	343	413	438	453
Machinery	–	–	–	–	54	108	114	123
Agricultural implements and tractors	–	–	–	–	35	81	83	77
Burlaps ... .mil. lb.	542	506	447	419	109	131	103	91
Wool manufactures	–	–	–	–	33	55	47	76
Cotton manufactures	–	–	–	–	24	45	43	65
Clocks, watches, and parts	–	–	–	–	54	60	51	57
Flax, hemp, and ramie manufactures	–	–	–	–	22	30	31	41
Vehicles and parts	–	–	–	–	13	46	21	34
Automobiles, including trucks .. .. number	2,302	29,279	84	21,811	2	31	10	21

* High year before 1950.
† Actual weight.
‡ Includes ores of ferro-alloying metals.
§ Less than one-half of unit specified.
‖ Refined in ingots, plates or bars.
§§ Copper content.
** Bars, blocks, pigs, scrap and alloy.
†† Pigs, bars and scrap.
‡‡ Lead content.

(Source: Department of Commerce.)

TABLE 4

United States Exports, General Imports and Balance of Trade, by Areas and Leading Countries

(Values in millions of dollars)

Continent, Area, and Country	Exports, including Re-exports			General Imports			Excess of Exports (+) or Imports (—)		
	1947	1949	1950	1947	1949	1950	1947	1949	1950
Total	15,340.3	12,051.1	* 10,274.8	5,755.7	6,622.3	8,841.9	+9,584.6	+5,428.8	+1,432.9
North America:									
Northern	2,114.5	1,959.2	2,016.1	1,128.1	1,552.1	1,958.3	+986.4	+407.1	+57.8
Southern	1,715.0	1,339.5	1,432.9	1,015.7	941.3	1,139.1	+699.3	+398.2	+293.8
South America	2,353.6	1,561.8	1,376.8	1,254.2	1,501.3	1,959.5	+1,099.4	+60.5	—582.7
Europe †	5,686.1	4,118.2	2,945.7	820.0	925.1	1,387.5	+4,866.1	+3,193.1	+1,558.2
Asia †	2,329.3	2,255.8	1,554.7	1,054.6	1,239.6	1,697.8	+1,274.7	+1,016.2	—143.1
Oceania	320.3	194.9	142.1	155.8	125.4	208.0	+164.5	+69.5	—65.9
Africa	821.5	621.8	361.6	327.3	337.5	491.8	+494.2	+284.3	—130.2
NORTH AND SOUTH AMERICA									
Canada ‡	2,073.7	1,940.4	2,015.9	1,095.1	1,512.1	1,957.2	+978.6	+428.3	+58.7
20 American Republics	3,857.8	2,721.0	2,668.0	2,167.6	2,301.0	2,907.2	+1,690.2	+420.0	—239.2
Mexico	629.9	468.2	515.7	246.7	243.5	317.7	+383.2	+224.7	+198.0
Central America	324.3	262.7	257.8	119.5	139.0	178.3	+204.8	+123.7	+79.5
Cuba	491.8	380.3	460.4	509.6	387.5	405.6	—17.8	—7.2	+54.8
Colombia	218.9	175.9	233.3	205.6	241.5	313.1	+13.3	—65.6	—79.8
Venezuela	426.8	518.4	398.4	173.5	278.1	322.0	+253.3	+240.3	+76.4
Peru	91.6	86.1	72.8	41.7	40.2	48.5	+49.9	+45.9	+24.3
Bolivia	28.3	36.2	20.5	39.5	48.5	34.4	—11.2	—12.3	—13.9
Chile	125.3	142.6	71.7	122.3	152.5	159.6	+3.0	—9.9	—87.9
Brazil	643.2	382.9	353.6	445.7	551.8	714.5	+197.5	—168.9	—360.9
Uruguay	75.5	34.7	40.2	37.8	54.0	106.1	+37.7	—19.3	—65.9
Argentina	679.9	130.8	144.6	154.6	97.5	206.1	+525.3	+33.3	—61.5
Netherlands Antilles	66.9	75.9	69.6	73.0	111.4	157.0	—6.1	—35.5	—87.4
EUROPE									
16 ERP countries §	5,295.9	4,075.7	2,878.2	695.3	842.4	1,259.5	+4,600.6	+3,233.3	+1,618.7
Belgium	534.6	307.7	270.3	58.6	94.2	139.6	+476.0	+213.5	+130.7
France	817.2	497.1	349.7	47.0	61.5	131.3	+770.2	+435.6	+218.4
Germany	585.3	822.1	439.8	6.3	45.5	103.7	+579.0	+776.6	+336.1
Italy	499.9	458.0	345.1	43.8	70.9	109.3	+456.1	+387.1	+235.8
Netherlands	383.7	283.4	228.0	26.5	59.3	84.0	+357.2	+224.1	+144.0
Sweden	397.6	87.4	99.4	92.6	54.4	71.3	+305.0	+33.0	+28.1
Switzerland	194.4	142.6	129.4	83.4	93.1	110.0	+111.0	+49.5	+19.4

	1947	1949	1950	1947	1949	1950	1947	1949	1950
United Kingdom	1,103.2	700.2	520.2	204.9	227.6	334.9	+898.3	+472.6	+185.3
Turkey	82.2	120.6	70.4	57.2	55.7	61.2	+25.0	+64.9	+9.2
10 Eastern European countries ‖	339.9	61.9	26.7	108.2	67.4	80.5	+231.7	—5.5	—53.8
U.S.S.R.	149.1	6.6	.8	77.1	39.2	38.2	+72.0	—32.6	—37.4
Other Europe	132.5	101.2	111.2	73.7	71.0	58.7	+58.8	+30.2	+52.5
OTHER CONTINENTS									
Western Asia, excluding Turkey	221.6	384.3	225.7	50.1	114.6	151.8	+171.5	+269.7	+73.9
Kuwait	11.8	22.6	3.2	.3	38.9	41.8	+11.5	—16.3	—38.6
Iran	34.0	113.5	35.2	23.4	16.4	23.6	+10.6	+97.1	—11.6
Israel and Palestine §§	31.7	79.2	94.2	5.1	6.0	8.0	+26.6	+73.2	+86.2
Saudi Arabia	67.5	84.8	33.2	2.5	19.9	24.2	+65.0	+64.9	+9.0
Far East	2,345.8	1,945.7	1,400.7	1,103.0	1,194.7	1,692.8	+1,242.8	+751.0	—292.1
British Malaya	65.8	37.6	20.6	284.1	195.5	308.7	—218.3	—157.9	—288.1
China	353.5	82.7	38.3	116.7	106.4	145.8	+236.8	—23.7	—107.5
Hong Kong	89.5	121.2	107.3	2.4	4.3	5.4	+87.1	+116.9	+101.9
Japan	414.5	467.5	418.2	35.4	82.0	182.0	+379.1	+385.5	+236.2
India	** 401.1	255.2	215.6	** 253.8	238.8	259.4	** +147.3	+16.4	—43.8
Pakistan	**	45.8	33.5	**	27.7	31.4	**	+18.1	+2.1
Indonesia	103.6	124.5	80.6	36.6	120.4	157.3	+67.0	+4.1	—76.7
Philippines, Republic of	439.5	439.2	240.3	161.7	204.7	234.8	+277.8	+234.5	+5.5
Australia	235.6	142.7	107.9	125.3	97.6	141.1	+110.3	+45.1	—33.2
New Zealand	76.8	42.6	27.8	27.6	24.4	64.4	+49.2	+18.2	—36.6
Africa:									
Algeria	47.7	26.4	15.5	1.8	4.1	5.1	+45.9	+22.3	+10.4
Belgian Congo	50.0	48.4	40.5	32.5	36.3	46.0	+17.5	+12.1	—5.5
British West Africa	35.8	14.9	12.3	84.7	82.4	99.5	—48.9	—67.5	—87.2
Egypt	60.1	52.8	32.8	28.1	9.4	54.6	+32.0	+43.4	—21.8
Union of South Africa	413.9	266.0	124.8	111.1	116.4	140.4	+302.8	+149.6	—15.6
Sterling area countries ††	2,833.3	1,886.7	1,306.5	1,203.6	1,194.5	1,601.4	+1,629.7	+692.2	—294.9

* Includes "special category" exports valued at $445,000,000 which are excluded from area and country data.
† Turkey is excluded from Europe and included with Asia.
‡ Includes Newfoundland beginning 1950.
§ Includes Iceland, Norway, Denmark, Ireland, Austria, Portugal, Free Territory of Trieste, Greece in addition to countries shown.
‖ Czechoslovakia, Hungary, Estonia, Latvia, Lithuania, Poland and Danzig, Albania, Rumania and Bulgaria and U.S.S.R.
§§ Includes Transjordan in 1947.
** Pakistan included with India in 1947
†† Data cover trade with countries in sterling area as of December 31, 1950.

(Source: Department of Commerce.)

TABLE 5

FOREIGN COMMERCE OF THE UNITED STATES

Year	Exports	Imports	Total
1800*	$ 71,000,000	$ 91,300,000	$ 162,300,000
1810	66,800,000	85,400,000	152,200,000
1820	69,700,000	74,500,000	144,200,000
1830	71,700,000	62,700,000	134,400,000
1840	123,700,000	98,300,000	222,000,000
1850	144,400,000	172,500,000	316,900,000
1860	333,600,000	353,600,000	687,200,000
1870	403,600,000	461,000,000	864,600,000
1880	889,700,000	697,000,000	1,586,700,000
1890	857,500,000	823,400,000	1,680,900,000
1900	1,477,900,000	829,100,000	2,307,000,000
1910	1,866,300,000	1,562,900,000	3,429,200,000
1920	8,228,000,000	5,278,500,000	13,506,500,000
1929	5,241,000,000	4,400,000,000	9,641,000,000
1930	3,843,200,000	3,060,900,000	6,904,100,000
1931	2,424,000,000	2,090,000,000	4,514,000,000
1932	1,612,000,000	1,323,000,000	2,935,000,000
1933	1,675,000,000	1,450,000,000	3,125,000,000
1934	2,133,000,000	1,655,000,000	3,788,000,000
1935	2,283,000,000	2,047,000,000	4,330,000,000
1936	2,415,000,000	2,420,000,000	4,835,000,000
1937	3,345,000,000	3,084,000,000	6,429,000,000
1938	3,094,000,000	1,960,000,000	5,055,000,000
1939	3,178,000,000	2,318,000,000	5,496,000,000
1940	4,022,000,000	2,625,000,000	6,647,000,000
1941	5,146.000,000	3,345,000,000	8,491,000,000
1942	8,080,000,000	2,745,000,000	10,825,000,000
1943	12,963,000,000	3,382,000,000	16,345,000,000
1944	14,412,000,000	3,921,000,000	18,333,000,000
1945	10,527,000,000	4,136,000,000	14,663,000,000
1946	10,187,000,000	4,909,000,000	15,096,000,000
1947	15,340,000,000	5,733,000,000	21,073,000,000
1948	12,614,000,000	7,070,000,000	19,684,000,000
1949	12,042,000,000	6,662,000,000	19,704,000,000
1950	10,142,000,000	8,735,000,000	18,877,000,000

(Source: Department of Commerce.)

Chapter 4

FINANCING FOREIGN TRADE—BILLS OF EXCHANGE AND LETTERS OF CREDIT

The Financing Function.—Modern production is usually a roundabout process involving several stages and large outlays of capital for labor, materials, and equipment. Until the goods are finally sold and paid for, the financial burden on the producer is frequently heavy. The marketing of goods is usually undertaken by a person other than the producer, and similarly involves an outlay of money. The entire expense of producing and marketing goods is on occasion borne by the producer alone, but ordinarily it is shared by the middleman and retail seller. A portion of the funds needed for the production and distribution of goods is also commonly provided by a bank.

Fundamentally there is little difference in the financing of foreign and domestic trade. In foreign trade the time interval during which trade needs financing is usually longer because goods are shipped greater distances. Furthermore, in foreign trade the importer frequently desires a longer period in which to pay. During this time he hopes to dispose of the goods. If they are raw materials, he hopes to work them up into finished products and sell them, thereby receiving money with which to make payment. The importer, of course, has some capital of his own, but he may lack enough to pay completely for his goods in advance of selling them. In international trade the finance burden is occasionally assumed entirely by the exporter and in some cases by the importer, but payment commonly involves the assistance of a bank.

Since buyer and seller are usually farther apart in foreign than in domestic trade, the exporter may find it more difficult to ascertain the credit standing of his customers. Conversely,

it is less easy for an importer to determine the integrity and reputation of the foreign firms from which he may wish to buy. In domestic trade the matter of the monetary unit is simple, whereas in international trade currency and exchange problems may complicate the financing and even prevent a transaction. In other respects the financing of foreign trade is not very different from that of domestic trade.

Methods of Payment.—Wide variations exist in the procedure of financing foreign trade. Certain customs and practices regarding financial arrangements pertain to the different commodities and to different countries.

The simplest, but by no means the commonest, method involves payment in advance, in which case the finance burden is borne largely by the importer. In such a case the importer makes payment by remitting to the exporter a draft when ordering the merchandise or before shipment.

Such procedure is exceptional in foreign trade. While ideal from the seller's point of view, this method is obviously disliked by the buyer, since he may lack ready funds for advance payment and may also consider it a reflection on his credit standing to be asked to remit prior to shipment. Moreover the buyer is thereby forced to accept all risks in transit, in exchange fluctuations where rates are unstable, and in the quality of goods received. Use of this method is ordinarily confined to financing shipments of samples, small amounts of consumers' goods, or made-to-order merchandise or to shipments in periods of uncertainty when a sudden crisis or governmental action might interfere with payment. When expensive products, such as special types of machinery, are made to order, some kind of advance-payment arrangement may be requested, although the entire price may not be asked for at one time. A common plan calls for the payment of one-third of the purchase price with the order, one-third upon shipment, and one-third within a specified period after receipt of the product by the buyer.

According to the open-account method, shipments of merchandise are charged to the account of the buyer as they are made, much in the same fashion that domestic retail stores ad-

vance credit to their customers. This procedure places the entire finance burden upon the exporter. It is of further advantage to the importer, since it ordinarily creates no legal obligation to remit at a definitely stated time, so that he is enabled to adjust his payments to receipts from customers.

The open-account method is avoided by many exporters, although convenient in that it eliminates the need for special papers and arrangements. A disadvantage is that it ties up large amounts of the exporter's capital. Furthermore, banks usually dislike to advance funds against accounts receivable, which fact may be a handicap to small firms that are asked to pledge collateral when borrowing. Also, aside from the finance burden, the exporter is largely at the mercy of the buyer's good faith, there being no documentary security. It opens the door for misunderstandings which may require acquiescence by the exporter in order to retain the good will of his customer. In the event of a dispute, the exporter must prove that the goods were delivered exactly in accordance with the sale contract. Laxity in making payment is encouraged, even though the importer may have no desire to evade his obligations.

Some of these disadvantages can be avoided by previous arrangements between the parties. For example, it is ordinarily agreed that payments are to be made at stipulated intervals, perhaps every three months. Interest is often charged on unpaid balances. The exporter generally sets a maximum credit limit beyond which the buyer cannot make further orders on credit.

Open-account financing is used less in foreign than in domestic trade, and it has been declining in importance in domestic trade. It is sometimes extended by exporting firms as an accommodation to foreign buyers of unquestioned standing, such as commission houses with long experience as buying agents for foreign importers. European exporting concerns which have had satisfactory business relations with their buyers for many years often employ open-account arrangements.

In arranging for a shipment of goods, the question of who is to pay the freight is always agreed upon in advance. The prices quoted by the seller may be f.o.b. (free on board) at a specified

location such as the factory, which means that the buyer pays the freight; if the terms of sale are c.i.f. (cost, insurance, and freight), these items are borne by the seller; the letters f.a.s. (free alongside) mean that the seller will deliver the goods alongside the ship, paying freight to that point.

The Bill of Exchange.—Thus far we have discussed only briefly the mechanics by which foreign payments are made or funds transferred from one country to another. To describe this involves a consideration of the draft, or bill of exchange, which is the fundamental instrument in international trade.

The draft is supposed to have been first introduced into international trade by the Lombardian Jews, early traders of northern Italy, who used it as a means of avoiding the shipment of large quantities of gold and silver. It is now used in virtually all international commercial transactions. The *bill of exchange* in appearance and function resembles the common bank check. It is an order signed by the maker, called the drawer, directing another party, the drawee, to pay a specified sum of money to a third party, the payee, at a certain future date.

Bills of exchange are ordinarily drawn by exporters in connection with shipments of merchandise, or are drawn by banks on other banks. The former are known as *commercial bills of exchange,* or *trade bills,* while the latter are known as *bankers' bills, bankers' drafts,* or *"bank drafts."* The commonest procedure is for the exporter, upon shipping his goods, to draw a bill either on the importer or, more frequently, on a bank acting for the importer. The exporter usually draws the bill payable to his own order, or to that of his bank. He then endorses the bill and sells or discounts it at his bank. In this way the exporter may receive his money immediately upon shipping his goods.

The bank which discounts or buys the bill is protected in two ways. It has the written endorsement of the exporter, which makes him legally liable to pay the draft if it is not otherwise paid. The bank also has possession of the bill of lading and other documents which the exporter turns over with the draft. The *bill of lading* is the receipt of the steamship company or

railroad for the goods and gives title to the goods. The bank can, if necessary, thus secure possession of the exported merchandise.

The bank mails the bill of lading, insurance papers, and other documents, along with the draft, to its foreign branch or correspondent bank, which, upon arrival, promptly notifies the importer and presents the draft to him for payment or acceptance. Until the importer has accepted the draft or made arrangements for payment, he cannot receive the bill of lading permitting him to get possession of the goods. In accepting a draft, the drawee (on whom the bill is drawn) writes the word "accepted" above his signature across the face of the instrument, thus becoming legally bound to pay the obligation when due.

If the draft calls for immediate payment, the foreign correspondent collects from the importer and then remits to the home bank, which is thus reimbursed for the funds advanced to the exporter. If the draft is a time bill and acceptance is called for, the foreign bank, after having the draft accepted, possesses an instrument which is guaranteed both by seller and buyer. The accepted draft is known as a *trade acceptance,* and can either be held by the foreign bank until due or, if funds are desired immediately, the draft can be sold in the open market—at a slight discount, depending upon the amount of time before the bill matures and the prevailing rate of interest for this type of paper. In the United States such bills can be rediscounted at federal reserve banks provided they are "eligible."

Whether the merchandise will be surrendered to the importer when he accepts the draft, or not until he makes payment, will depend upon whether the arrangements provide for "documents against acceptance" (written D/A) or "documents against payment" (D/P). Sometimes the merchandise is placed in a warehouse and parceled out to the importer a little at a time as he sells the goods and makes payment. The warehouse gives the bank what is known as a warehouse receipt; sometimes banks have their own warehouses. This procedure involves difficulties and is avoided if possible.

If a draft is drawn and sold "without recourse," the exporter is relieved of liability in case of nonpayment or other loss.

British and American banks, however, usually refuse to discount such bills because of the risk involved. Drafts of this kind are not eligible for rediscount at federal reserve banks.

Trust Receipt.—When the arrangement is that the documents are to be turned over to the importer only against payment and the importer is unable to make payment, the merchandise may be made available to the importer by his bank under an arrangement whereby the importer signs a *trust receipt*. The importer thus receives the goods in trust and does not obtain title to them. The trust receipt is also used in some cases when a bank delivers documents to an importer after having accepted a time draft for him. The trust receipt provides that the importer shall be the agent of his bank in the sale of the imported goods. The bank retains ownership of the merchandise until the importer has made full settlement, and all sums received from the sale of the goods must be credited to the bank until such settlement is made. Any losses that occur under a trust receipt are borne by the bank and not by the exporter.

Bank Drafts.—In addition to the commercial bill, as noted above, is the *bank draft*, which is drawn by one bank on another bank. This is a common type of draft for making foreign remittances. Bank drafts are used when an individual or corporation in one country desires to remit, for whatever purpose, to someone in a foreign country. A frequent use of this type of draft is when an importer requests his bank to draw a draft on a bank in the exporter's country, payable to the exporter. The importer pays for this draft, which he then sends to the exporter, who cashes it at his own bank.

When a bank draws upon a foreign bank, it, of course, has an account in such foreign bank, or arrangements whereby drafts can be drawn upon the bank. Banks have arrangements whereby they can draw drafts on some bank in practically every important city of the world.

Bankers' Acceptances.—When an exporter draws a draft on a bank, the draft, after being accepted by the bank, is known as a *bank acceptance* or *banker's acceptance*. Such drafts are usually drawn by exporters on the bank of the importer under a

letter of credit provided by the importer, as discussed below. Bankers' acceptances are obligations of high quality and can easily be sold in the discount market.

Instead of buying, or discounting, a bill for an exporter, the exporter's bank may grant him credit in the form of a bank acceptance. In this case the exporter arranges the financing with his own bank and draws a draft on it, which the bank agrees beforehand to accept. The resulting bank acceptance is a negotiable instrument which the exporter may readily sell in the open market. In addition to the bank acceptance, a draft is drawn at the same time on the foreign importer and a copy retained by the bank. This draft, with documents, is sent to a foreign correspondent bank for presentation to the importer, as in the above instance. The exporter's bank must pay unconditionally its own accepted draft when due, but the bank has the same security as though it had discounted the draft on the importer or the importer's bank, namely, the bill of lading and the exporter's guaranty to meet any losses, embodied in an acceptance agreement which the exporter signs.

The advantage of this procedure for the bank is that it does not need to pay out any of its cash, even temporarily, presumably being reimbursed from the importer's draft before its own accepted draft becomes due. This method has long been used in England, and is widely employed in the United States and elsewhere. A similar procedure is frequently used by importers. An importer, when paying a draft drawn by an exporter, may draw on his own bank in order to refinance himself.

Drafts for Collection.—When a bank does not wish to buy or discount an exporter's bill of exchange, it may act as collecting agent. The bill is then forwarded to a foreign correspondent bank which presents it to the importer for payment or acceptance, whichever the arrangement requires. Where drafts are placed for collection, banks generally provide a blank form covering the most important points of instructions so that the exporter's interests will be protected. Charges for collection usually amount to between 1/8 and 1/4 of 1 per cent plus charges which may be made by the bank's correspondents.

Usance of Drafts.—The length of time a bill of exchange has to run before payment is known as its *usance* or *tenor*. *Sight drafts* are those payable immediately upon presentation to the drawee. *Time drafts,* as their name indicates, run for various periods of time; for example, sixty or ninety days.

The date of payment is usually contingent upon the time when the bill is presented to the drawee. Since time drafts usually do not begin to run until accepted by the drawee, they are presented promptly for acceptance, which thus fixes their maturity. A bill may read "90 days after date" or "30 days after sight" or "60 days after acceptance"; or the draft may provide, as a concession to the importer, that it is "not payable until after arrival of merchandise." A so-called *arrival draft* of this type often results in confusion, since there is sometimes debate over what is meant by arrival when delivery at the port of entry is delayed. *Long bills* are time drafts drawn for longer than thirty days, while *short bills* are considered as those running for thirty days or less. Few bills are drawn for more than ninety days, except in South American trade.

In the case of cables, or *telegraphic transfers,* referred to by the letters TT, a bank telegraphs a foreign bank to pay a certain amount of money to a designated payee. In this manner immediate transfer of funds is accomplished without waiting for transmission by mail.

Documentary Drafts.—Documents which usually accompany a draft include the commercial invoice, the bill of lading, and the marine insurance policy or certificate. In addition to these documents, others are often required, such as the consular invoice and the certificate of origin. The *invoice* is the description of the merchandise which the exporter makes for his customer and also for the government. The bill of lading constitutes both a receipt from the shipping agency and a means of conveying title. The insurance certificate protects the parties interested in the shipment against possible loss or damage en route. The *hypothecation certificate* is an instrument giving the holder of the draft power to sell the merchandise for what it will bring in the event of nonpayment by the importer, and

also to recover from the exporter any losses that may occur. The documents, including the draft, are made out in duplicate (three copies generally being made of the bill of lading), and a complete set of each is often sent by different ships or planes to insure arrival at destination.

Drafts which are unaccompanied by documents are known as *clean drafts.* Such bills are less attractive from the standpoint of security than the *documentary drafts* described above, and banks generally refuse to buy or discount them. Consequently, in international trade the documentary draft is used almost exclusively, since the documents, when properly executed, give control over the shipment and make possible ready transfer of title to the goods.

The Price of Bills.—The prices of the different kinds of bills, or drafts, are not the same. Sight drafts, other things being equal, are worth slightly more than time drafts, because of the loss of interest on time drafts. The value of a bill tends to vary inversely with the length of time it has to run. If payment by the importer is to be made by time drafts, exporters, in quoting their prices, ordinarily make allowance for the greater discount charged by banks on time drafts. Thus the terms of financing influence the prices at which exporters are willing to sell their goods.

The credit standing of the drawer and of the drawee also influence the price which a bank will pay for a draft. An exporter who has a good reputation of long standing can obtain more for the bills he draws than can someone who is not well known. Likewise, a draft drawn on an importing firm of unquestioned standing will secure a more favorable price than one drawn on an importer whose reputation is not established. If the exporter's bill is drawn on a bank, under a letter of credit, its value is still greater.

Another factor in the price of a draft is the nature and degree of security afforded by the documents attached; this is sometimes responsible for considerable price variation.

The currency in which a bill is drawn also influences the amount it will bring. Some currencies are unstable and involve

more risk than others, or for various reasons are less desirable. Drafts are ordinarily not drawn in currencies for which there is little demand since they may have to be sold at an unfavorable discount or are perhaps not salable at all.

In view of the prevalence of exchange restrictions and the consequent difficulty of transferring funds from certain currencies into dollars, drafts covering trade with the United States are drawn very largely in dollars. In some countries the obtaining of a license to buy dollars is difficult or involves a delay, particularly if the goods imported are not in an essential category. An American exporter, therefore, ordinarily draws his draft in dollars, preferably on a bank under a letter of credit. The issuance by the bank of such a letter of credit in dollars probably requires permission from the local exchange control office and is ordinarily assurance that the government will permit the payment of dollars to the United States exporter as provided in the letter of credit. If the draft is not drawn under a letter of credit, the foreign importer may experience difficulty in obtaining the dollars with which to pay the draft when due. Even under a letter of credit, a long wait may be necessary in the case of some countries. An exporter to such a country must be prepared to wait beyond the period arranged in the terms of sale. Exchange difficulties of this kind are unfortunately not uncommon and are a serious handicap to foreign trade.

The Commercial Letter of Credit.—The ordinary commercial draft, discussed above, provides no assurance that the importer will accept or pay the draft, or that he will take the goods sent to him. Consequently, exporters commonly require the protection afforded by the commercial letter of credit, an instrument widely used in international trade throughout most countries of the world.

A letter of credit is a document containing the guaranty of a bank to honor drafts drawn on it by an exporter, under certain conditions and up to certain amounts. Instead of being drawn on the importer, the draft is drawn on the importer's bank, which has agreed to act for him. The credit of a bank is or-

dinarily much higher than that of an importer, and the letter of credit provides a means of substituting the bank's credit for that of the importer.

A letter of credit eliminates much of the risk for the exporter, since a bank guarantees that he will be paid for his shipment, provided, of course, he follows instructions and provided exchange restrictions do not delay matters. Furthermore, he can dispose of drafts drawn under a letter of credit at the best prices available. He, therefore, ordinarily requests the importer to provide him with a letter of credit. If the importer is not located in a well-known financial center, he will arrange through his local bank for a letter of credit on some large bank to be sent to the exporter. The draft which the exporter draws under a letter of credit is supported by documents as in the previous case.

Shipments Under Letter of Credit.—As an illustration of a transaction involving a letter of credit, let us assume a shipment of coconut oil (or copra which is the material from which coconut oil is derived) from Manila to San Francisco, payment to be made to the Philippine exporter in American dollars. In the preliminary correspondence, the exporter and importer have made arrangements with regard to the various details for the sale, including price, the tenor or usance of the draft to be drawn, 90 days' sight, provision for the opening of an irrevocable letter of credit in favor of the Philippine exporter and various other matters.

The American importer fills out a formal application requesting his bank in San Francisco to open the desired letter. In this application he states the principal terms of sale which have been agreed upon, indicating the documents to accompany the draft, the tenor of the draft, the latest date of shipment, and other details. Banks do not desire too much detail regarding the description of the merchandise, since this opens the door for dispute. If the bank decides to arrange the credit the importer signs the letter-of-credit contract in which he promises to reimburse the bank for all outlays and to give such security as the bank may demand.

The bank thereupon notifies its correspondent in Manila requesting it to confirm the credit to the exporter. The Manila bank informs the exporter that an irrevocable and confirmed letter of credit has been arranged, and describes the terms under which shipment must be made before the draft will be honored. The contract is now binding on both the San Francisco bank and the Manila bank. Alternatively the Manila bank may not confirm the letter of credit but merely advise the exporter that the bank has received word that the credit has been opened.

The Philippine exporter puts his copra on board a ship bound for San Francisco, preparing all documents as specified by the letter of credit. He draws his draft, a ninety-day bill as previously arranged, and sells it to his bank in Manila. The draft being in American dollars is drawn against the San Francisco bank. The Manila bank that buys the draft pays the exporter in Philippine pesos according to its current buying rate for drafts of this type. The exporter has now made his shipment, drawn his draft, and received his money.

The draft and accompanying documents are sent by the Manila bank to some San Francisco bank other than the one on which the draft is drawn and which issued the letter of credit. Upon arrival in San Francisco the draft is presented by the bank receiving it to the bank on which it is drawn to have it accepted. The draft now becomes a bank acceptance, and is retained by the bank presenting it. The accepting bank, however, is entitled to the documents in view of its acceptance, and takes possession of these turning them over to the importer, perhaps against a trust receipt, so that he can receive the copra. If the Manila bank wishes to be reimbursed immediately, it instructs the bank in San Francisco to which it sent the draft to discount it in the open market and remit the proceeds, or to deposit them to the Manila bank's account in San Francisco, so that the Manila bank can draw drafts against this money. If it is in no hurry for the money, it may wait the ninety days and receive the interest involved.

It can be seen that the commercial letter of credit has a number of advantages both to exporter and importer. For the exporter the credit risk is virtually eliminated. He need not worry

about the credit of his customer, since the draft is drawn not on the customer but on a bank—often a bank in the exporter's own country. Consequently, the exporter's draft can be sold or discounted at the most favorable terms. While most of the responsibility is placed on the importer, a letter of credit is not without its advantages for him, since he can then secure the best prices from the exporter, and is assured that the shipment will very likely be made not later than the date stipulated in the letter of credit, and that no payment will be made until shipping documents have been surrendered by the exporter.

In the case of countries with uncertain or not well-known currencies, letters of credit are often expressed in neither the currency of the buyer nor of the seller, but in terms of the currency of a third country. Prior to the first World War, this third country was usually Great Britain. Even American foreign trade was generally financed in terms of British pounds sterling. After the war, however, the American dollar came to be widely used all over the world. Since the second World War the dollar is used to even a greater extent. In such cases, where the currency of a third country is utilized, the letter of credit is issued by a bank in the importer's country, as before, but is confirmed by a bank not in the exporter's country but in the third country. The exporter thus draws his draft on the confirming bank.

An example will make this clear. A Brazilian importer of tobacco from Egypt might arrange through his local bank for some London bank to issue a letter of credit to the Egyptian exporter, the credit being in British pounds sterling. The tobacco exporter would draw his draft on London in sterling, sell it to his own bank in Cairo for Egyptian pounds, which would forward the draft to its London correspondent to have it presented to the bank in London on which it was drawn for acceptance. The accepting bank would detach the documents and send them to Brazil, so that the importer could receive his tobacco. As the date of maturity of the draft approached, the Brazilian importer would be asked by his local bank to supply it with a draft on London to be sent to the accepting bank there for covering the draft about to fall due.

Types of Letters of Credit.—Letters of credit are of several kinds. A sight letter of credit is one which authorizes the exporter to draw a sight draft on a certain bank, while a time letter of credit permits him to draw a time draft, which the bank accepts. The bank acceptance can, of course, easily be sold or discounted if the money is desired immediately.

An "irrevocable letter of credit, confirmed" is the type dealt with in the preceding illustrations, and is sometimes insisted upon by exporters. It represents the unconditional guaranty of both the opening and confirming banks that the exporter's draft will be honored under the conditions specified. This form offers the greatest degree of protection to the exporter. The "irrevocable letter of credit, unconfirmed," widely used, represents the unconditional guaranty only of the issuing bank that the draft will be paid or accepted. The foreign correspondent bank may not confirm the letter of credit to the importer but merely advise him that the bank has received notice that the letter of credit has been issued.

A "revocable" letter of credit may be canceled by the bank at any time, and hence is not a very satisfactory document. Some banks refuse to issue them, since sudden cancellations often result in disputes and litigation. Such letters are now rarely used.

A "revolving" credit allows a number of transactions to be made with the same letter. This is the most convenient way of handling small shipments made at frequent intervals, much delay and expense being avoided. Often the letter is issued for a specific amount available monthly over a continuing number of months—usually six. Revolving letters of credit are not often used in the United States since banks are thereby deprived of the opportunity to review a commitment for additional funds. They prefer an arrangement whereby they are approached regarding an increase in the credit by the amount used.

An instrument somewhat similar to, but not to be confused with, the letter of credit is the "authority to purchase" (A/P). Originating in the Far East it is used chiefly by Chinese importers. The importer arranges for the authority to purchase

with his local bank, which then notifies its foreign correspondent that it (the correspondent) is authorized to buy the exporter's draft under conditions stipulated. The draft is drawn not on the bank but on the importer, who agrees to reimburse his bank for such advances as it may make in connection with the draft. The bank does not guarantee payment of the draft.

Generally speaking, the authority to purchase is not looked upon with favor by exporters, since it provides no guaranty of payment on the part of a bank. The exporter endorses the draft when he sells it to the bank, and may find the draft back on his hands unpaid. An authority to purchase specifically states that it is not a bank credit and that the issuing bank may at any time, without prior notice, decline to negotiate any bills thereunder presented to it.

Another instrument is the "authority to pay," which is used by some banks in place of the revocable letter of credit. This is issued by the importer's bank, and simply states that drafts may be presented to it for acceptance or payment, with no guaranty, however, that they will be honored. The form advises the seller that it is for guidance in preparing documents. It does not pretend to be a commercial credit, although in practice it is somewhat similar. The "authority to pay" is generally regarded as of little value, unless it is "irrevocable without recourse," in which case it is as good as a letter of credit.

Chapter 5

FOREIGN EXCHANGE AND THE EXCHANGE MARKET

The Rate of Exchange.—Practically every nation has a monetary unit different from that of other nations. In a few instances the units appear similar, as in the case of the United States and Canada; but the Canadian dollar and the American dollar are, of course, not the same. In Great Britain the currency unit is the pound sterling, divided into 20 shillings, or 240 pence; 12 pence thus make 1 shilling. The currency of Great Britain, it will be noticed, is not based upon the decimal system.[1] In France the unit is the franc, divided into 100 centimes, and in Germany the mark, divided into 100 pfennigs. Wherever we go we find different units, although sometimes with similar names.

In all countries there are people who are continually wanting to convert some of their own money into that of another country, perhaps to pay for goods imported or for a variety of other reasons. For example, Mr. A in New York wishes to send money to his mother who is in England. He has $1,000 to remit, but his mother must have pounds, not dollars. He is, therefore, ready to offer American dollars in exchange for British pounds. He knows from experience approximately the price he will have to pay in dollars to buy one British pound.

The price of one currency in terms of another is known as the rate of exchange. Thus, the rate of exchange in New York on London has at various times been $4.86, $4.03, $2.80 etc.

[1] The guinea consists of 21 shillings or one shilling more than a pound, but is not used extensively any more. The smallest denomination in Great Britain is the farthing, worth one-quarter of a penny. The symbols of British money for pounds, shillings, and pence are £, s, and d, so that 2 pounds, 5 shillings, and 6 pence would be written *£2 5s. 6d.*

The rate is the amount of American money required to buy £1. During recent years, especially since the establishment of the International Monetary Fund, the exchange rates of most countries have remained fixed for long periods of time. Sometimes an exchange rate is quoted as the number of foreign units which can be bought with the domestic unit. Thus, in London the rate on New York refers to the number of dollars to the pound rather than the cost in pounds of one dollar. In most Latin-American countries this same system of quoting dollars prevails. Before the first World War, German marks were quoted in New York as the number of marks to the dollar, so that the mark, instead of being quoted as about twenty-four cents, was quoted at a fraction over four.

At the same time that Mr. A in New York is offering to sell his dollars in exchange for pounds, Mr. B, also in New York, is the owner of pounds in London. He has sold some goods to persons in Great Britain and has deposited the proceeds from the sale to his credit in a London bank, or he has a draft payable in pounds to his order. If he and Mr. A should happen to get together, he could sell his pounds to Mr. A, and thereby receive American dollars which he would like to have.

Mr. A, however, may not want the exact number of pounds which Mr. B possesses, nor at the time that they are available. In order to facilitate matters, a bank or foreign exchange banker comes into the picture. The bank buys the pounds from Mr. B and from others who are in possession of pounds and who wish to convert them into dollars, and then sells the pounds to Mr. A and to others who wish to buy pounds and pay dollars. The bank makes a profit on the transaction in that its buying and selling rates are not identical; it buys the pounds for slightly less than it sells them.

In the United States, as in other countries, there is at any moment a large number of people desirous of buying pounds (also other foreign currencies), and at the same time a large number of people desirous of selling pounds (also other foreign currencies). The two groups cannot do business with each other directly for practical reasons, so they deal with foreign exchange bankers or with the foreign exchange departments of

commercial banks. Banks buy foreign drafts or bills and are therefore in a position to sell bills payable in whatever foreign currency may be desired.

Mr. B probably sold the bank a draft for so many pounds payable to his order, due on a certain date and drawn on a London bank—a piece of paper not unlike an ordinary American check. The draft was probably for an amount which would not exactly suit the needs of Mr. A. The bank thus serves a useful purpose in buying these drafts, depositing them in its foreign account and then selling to other persons drafts on this account in the exact amounts desired and payable to whomsoever desired.

Banks which make a specialty of dealing in foreign exchange keep funds on deposit in the leading financial centers of the world, and can draw drafts upon these funds payable to whomever requested, and at any future time requested, upon demand, sixty days, ninety days, or more from date. As regards smaller centers where the bank does not maintain funds of its own, arrangements are made with other banks providing for the drawing of drafts on these foreign centers. An American bank may keep a deposit in a bank in London, which in turn has funds in many continental and other foreign cities or has correspondent relations with banks in these cities. An American bank by various arrangements is enabled to draw drafts on banks all over the world and to sell them to its customers for dollars.

Banks are ordinarily in competition with each other, so that the rates which they quote customers are practically identical at any one time. They are in constant touch with what is happening abroad, and also in their own market. Thus, rates in New York on London, Paris, or other cities differ but slightly from bank to bank. Regulation of foreign exchange sales by governments and the policy of maintaining relatively fixed rates have narrowed the fluctuations but not eliminated them entirely.

Supply of Bills.—The question arises as to what determines in a free market the rates between dollars and pounds, dollars and francs, or dollars and other currencies. Why does the pound cost about $2.80 instead of $5.00 or $2.00? In the ab-

sence of regulation, why do the rates fluctuate from time to time, and what determines the rates between pounds, francs, marks, lire, pesos, and the various other foreign currencies?

Assume for the moment that rates are free to move in response to market forces. The rate of exchange which a New York bank charges for a particular foreign currency is determined immediately by the demand and supply in New York for that particular currency. If the supply of pounds on the market is large, foreign exchange bankers will reduce the price they offer for pounds. Similarly, the price which they charge for the sale of pounds will be less, so that they will be able to dispose of the pounds which they are buying. For example, if pounds are quoted at \$2.81, and a heavy offering of pounds takes place, perhaps because of financial disturbances in London or of exports to London, the increase in the supply offered in New York will tend to push the rate down toward \$2.80 or \$2.79. On the other hand, if the demand in New York for pounds increases, perhaps because of financial uncertainties in America and the desire of persons here to send their money abroad, or because of large imports from London, the price of pounds will tend to rise toward \$2.81 or more.

In other words, the rate of exchange which prevails in the market at any one time, under a free system, is the price which will equilibrate demand and supply. The principle is fundamentally the same as that involved in the determination of any price. This, however, is only a surface explanation and does not take us very far. The real question is, What makes the supply what it is, and the demand what it is, and why do these change? The answer to this question is not simple. It is dealt with in sections and chapters which follow.

The supply of foreign drafts comes from many sources. Persons and businesses come into possession of foreign money in a variety of ways. First, we have the American exporter who perhaps has sold a shipment of cotton to a British firm in Manchester. As a result of the sale, he is entitled to draw a draft on the British importing firm, or perhaps upon the importer's bank for £1,000 which is due him. He may have received a letter of credit sent to him from London showing his authority

to draw such a draft against the cotton exported. In any event, he takes the pound draft which he has drawn to his bank which buys it and credits his account with American dollars. In the event that the draft should not be paid in London, the American bank which bought it would, of course, look to its customer, the exporter of the cotton, for reimbursement.

The exporter of the cotton has, as a result of the shipment, brought into existence a supply of pounds available for sale on the American market. The pounds are bought by the American bank, deposited to its account in London, or perhaps to the London account of some other American bank in the event that the first bank has no account in London, and they are available for sale to anyone in America desiring such foreign currency. Exports of merchandise ordinarily create the largest portion of the supply of foreign bills.

Another source of supply of foreign bills is companies which render various services to foreigners, shipping companies, banks, legal firms, or moving picture companies which receive royalties from films exhibited abroad. The types of services rendered to foreigners by Americans are numerous, and place the American rendering the services in possession of foreign money; this money is then offered to banks in exchange for American dollars.

Foreign travelers visiting in America need dollars for expenses. They go to American banks and present drafts on their foreign banks, or letters of credit entitling them to draw drafts on such banks, and ask for American currency. Such transactions provide another source of foreign bills for American banks.

Foreigners who owe interest on money previously borrowed from Americans also provide a source of foreign bills; similarly with respect to principal repayments. The foreign currency that the debtors pay is sold for American dollars. In the case of foreign bonds the debtor probably buys dollars and remits the money due directly to some American bank or financial institution which acts as agent. The American bank pays dollars, not pounds or francs, to the American creditors. This was the customary procedure as regards the many foreign bonds sold in

this country during the twenties and on which interest and principal were payable in American dollars. Earnings on investments that Americans have made abroad are also a source of foreign currency and are increasingly important in the balance of payments.

Another source of supply of foreign funds is the influx into this country of foreign capital for safekeeping or investment in the United States. Such investment requires American dollars so that the foreigners offer their own currency in exchange for dollars.

Many other sources of foreign bills of exchange exist, but the above transactions account for the great bulk of foreign money offered for sale in the United States.

Demand for Bills.—Turning to the demand side, we find that the demand for foreign funds comes also from a variety of sources, which are largely the reverse of those above. The largest single demand for foreign bills is from American importers of foreign merchandise. Then we have the demands of American travelers abroad who need foreign money to pay traveling and other expenses. Some of this money is purchased prior to departure, but the larger part is obtained in the foreign country. Americans abroad sell their dollar travelers checks or draw drafts against their letters of credit and offer the dollar drafts to foreign banks in exchange for the needed local currency.

The sources of supply and demand for foreign funds coincide with the credit and debit items respectively in the balance of international payments, discussed in Chapter 8. The export of merchandise, and services rendered, which are credit or receipt items, provide Americans with foreign funds, while an import or services received, which are debit or payment items, create a need or demand in America for foreign funds.

Factors which cause changes in the amounts of foreign currency demanded, or the amounts supplied, involve fundamental economic and financial forces. They have to do with such things as price movements, changes in national incomes, fiscal policies, technology, production, trade restrictions, and political

conditions. Changes in these items have many ramifications and exert an important influence upon the demand and supply of bills, and therefore upon exchange rates, although the effect upon exchange rates may be concealed for a time. These questions are discussed below, but it should be noted here that a mere enumeration of the sources of demand and supply does not explain the level of exchange rates.

Par Values; Gold Export and Import Points.—The par value of a currency is the value as officially defined in terms of gold, or under the silver standard, when there was such a standard, in terms of silver. The expression "par of exchange" therefore applies only between countries having a fixed metallic content for their currency units.[2] The United States dollar contains approximately 13.71 grains of pure gold. Until January, 1934, the dollar was defined as 23.22 grains of gold 1,000 fine. The fineness or quality of metal in money is expressed in terms of thousands, so that if a coin has 10 per cent alloy and 90 per cent pure metal, it will be shown as .900 fine. In Great Britain the former pound sterling contained approximately 7.988 grains of gold .916 2/3 fine; the gold standard based upon this unit was abandoned in September, 1931.

For the sake of simplicity let us assume we are back in the first part of 1931 when a relatively free gold standard existed in many countries, and ignore for the moment the currency changes since then. By arithmetic we find that the pound sterling contained 4.8665 times the amount of pure gold of the American dollar as it then existed. The rate, therefore, of 4.8665 was the par of exchange between pounds and American dollars, as both currencies were then constituted. It meant that the gold pound weighed nearly five times as much as the gold dollar.

The 1914 French franc contained about one-fifth the gold of the American dollar, so that the par between francs and dollars was at that time 19.29 cents per franc. The gold content of the franc was reduced in 1928, so that the franc was worth then

[2] It would be possible to define a currency's par value in terms of another currency such as the dollar or pound sterling, but usage confines the meaning of par to the official value in terms of gold.

about 3.92 cents. In January, 1934, the gold in the American dollar was reduced to 59.06 per cent of its previous amount, so that the par with francs became about 6.63 cents per franc. In October, 1936, the franc was again devalued to bring it into line with the pound and dollar. The franc became worth about 3 cents, but was not given a precise gold content. Then came the war and postwar changes discussed below.

No country today is on the gold standard as this standard formerly existed, wherein currency was freely redeemable in a fixed amount of gold and wherein gold was permitted to move in and out of the country without restriction. In the case of such a country the par value played an important role and was the point around which market exchange rates tended to fluctuate. Rates of exchange could not depart far from par. No one would pay much more than par for a foreign currency since domestic gold could be exported to that country and converted into money there at par. The desired foreign money could thus be obtained at a cost represented by par plus expenses of shipping the gold.

An illustration will make this clear. When the United States and Great Britain were both on the free gold standard in 1931, if a person desired a draft on London and was quoted a price of $4.90 per pound whereas par was about 4.86, he could ship American gold to London and when it arrived present it at the Bank of England and receive pounds at the rate of one pound for every $4.86 of American gold. If gold coins were sent they would be accepted by weight, so that if they were worn they might not yield quite the full face value. Gold bars are shipped in international trade more extensively than are coins. The cost of shipping the gold, including insurance, loss of interest, transportation, and other costs would be less than two cents per pound sterling. Therefore he would not pay a premium above par greater than the cost of shipping gold. This point above par at which it paid to export gold was known as the gold export point. Under ordinary conditions it was the maximum rate which could prevail for a foreign currency on the gold standard.

The gold import point was the reverse of this. If a person

had a pound draft for sale and was offered a rate, for example, of $4.82 per pound, the owner of the draft could more economically import British gold. For each pound imported he would receive $4.86 of American money. The gold import point thus placed a lower limit on exchange rate fluctuations. Prior to September, 1931, market fluctuations between dollars and pounds were held between the narrow limits fixed by the gold export and gold import points, so that the rates did not go much below $4.85 nor rise much above $4.88.

Private persons, of course, seldom engaged in the shipment of gold. These operations were commonly carried on by the large banks when they could see a chance for a profit. When the United States and Great Britain were both upon the gold standard, if the demand in New York for London funds became strong and the rate tended to rise above 4.88, a New York bank might ship American gold to London since this might be the cheapest way to replenish its supply of pounds. Drafts could then be sold by the bank against the gold shipped.

Exchange rates needed to depart only fractionally above or below the cost of shipping gold for banks to engage in the export or import of gold. Banks were on the alert for profit and any profit, no matter how small, was worth the effort, since the costs of the transaction could be figured accurately and there was almost no risk. As soon as the gold was shipped, or even prior to shipment, a bank could sell drafts against it.

As a result of the currency changes of recent years, the gold points now have little practical significance. Gold shipments seldom take place automatically as a result of free foreign-exchange movements nor are they made by commercial banks. Gold shipments are ordinarily undertaken by governments and central banks in order to acquire needed foreign exchange or to make special payments. Most countries, however, especially members of the International Monetary Fund, still define their currencies in terms of gold and thus continue to have gold par values.

Exchange Rate Fluctuations.—When countries no longer redeemed their currencies freely in gold nor permitted free gold

exports, the stabilizing influence of gold movements no longer existed and the rates prevailing in the market were demand and supply rates with no limits on either side. Market fluctuations were often wide. Thus, when Great Britain went off the gold standard in September, 1931, the pound sterling dropped sharply and by late 1932 the rate was only $3.14. Had it been possible to export gold from Great Britain, no American owner of a British draft would have accepted such a low price. Instead he would have imported gold and received $4.86 for each sovereign of British gold. As a result of weakened confidence in the pound, the offerings of pounds were heavy and a low rate was required to absorb the offerings.

After the United States in 1933 abandoned free redemption in gold, the rates on London rose and reached $5.52 by the latter part of that year. This rise in sterling was partly because foreigners were now afraid of the American dollar, and there was a consequent heavy offering of American dollars for foreign currencies as foreigners sought to withdraw funds from the United States. From the standpoint of the New York market, there was a strong demand in New York for foreign drafts to remit to foreign owners of American funds. Some Americans were also nervous about the dollar, and accordingly sent their money abroad. From whichever side of the Atlantic the matter is viewed, the condition was one of a large offering of dollars against pounds and other foreign currencies, so that prices for pounds and other currencies rose in terms of dollars.

After the abandonment of the free gold standard wherein gold movements tended to hold market exchange rates close to par, governments, or their central banks, soon undertook to reduce fluctuations and to maintain rates relatively stable by various devices. This procedure had been developing since the end of the first World War, but came to the fore as the depression of the 1930's and the decline in foreign trade and investment depleted exchange reserves and disrupted rates. According to this system the government would enter the market either as a buyer or seller of bills, and by large sales or purchases influence the rates. In order to be able to sell foreign drafts, the government, or some agency of the government, needed to maintain

ample balances abroad. Or, if the government had a gold reserve, it could export gold. This enabled the government to sell foreign drafts if exchange rates rose higher than the government desired. If the rates, on the other hand, declined, the government could buy foreign bills paying out domestic funds, and thereby absorb the surplus bills from the market. Large so-called equalization or stabilization funds were established for this purpose by Great Britain, the United States, and other countries.

Stabilization operations of this type were to a large extent superseded by what is known as exchange control. According to exchange control systems, a license is required to purchase bills of exchange. Furthermore, the sale of bills must usually be to a government agency, which thereby exercises control over the exchange market, apart from the illegal black market and sometimes a small free market for certain kinds of transactions. The rates of exchange are officially fixed, and sometimes differ for different kinds of transactions. The official rates are usually at levels involving less depreciation than those which would be required to equilibrate demand and supply. A shortage of foreign currency is usually the initial reason for exchange controls, which are instituted in order to avoid rate depreciation. Through controls the limited supply of foreign exchange is rationed for the kinds of transactions desired, especially for the import of essential commodities. Although exchange controls are sometimes necessary temporarily, their effects, as discussed below, are usually harmful in that they tend to reduce the volume of trade and to distort production from the most efficient patterns. When they perpetuate uneconomic exchange rates they interfere with international price and cost relationships conducive to a large and healthy trade.

Of a different nature are stabilization efforts which recognize fundamental economic trends, and which aim to iron out only the short-time ups and downs of rate fluctuations. Such efforts do not involve restrictions upon the free purchase and sale of bills, but approach the problem through endeavoring to increase the immediate supply of foreign exchange or through absorbing surplus offerings, according to the requirements of

the situation. They do involve, however, the evils of fluctuating rates.

When exchange rates were permitted to fluctuate they were often subject to seasonal movements. Thus, in the fall of the year when American cotton and other agricultural crops were being exported, a large supply of foreign bills drawn against these exports existed and had a tendency to result in a slight decline in the rates, unless other influences offset this.

Foreign Exchange Procedures.—In the previous illustration, it was assumed that the American exporter of cotton drew a draft on the British importer (or on the importer's bank), and that he then sold the draft for dollars to his own bank in America. This is a common procedure, but several variations are possible, according to the arrangements that have been agreed upon. The American exporter, instead of drawing a draft in pounds, may be sent a draft on an American bank payable in dollars, purchased by the British importer of the cotton who paid for the draft with pounds. Another procedure would be for the British importer to send to America a draft on London payable in pounds, although this method is not common. It would necessitate the selling of the draft for dollars by the American exporter. Whatever method is used, the draft might be payable at sight or at some future time. Custom determines to a considerable extent what particular method is followed. Regardless of the method of payment, there is involved payment by someone in Great Britain to someone in the United States, which means the offering of pounds in exchange for dollars.

From the standpoint of the demand and supply of pounds and dollars, London and New York may be viewed as two parts of the same market. In the first illustration, when the American cotton exporter draws a bill on London and sells it to his bank, an American bank receives pounds (which it can subsequently sell), and pays out dollars. If, on the other hand, the British importer goes to his London bank and buys a dollar draft on a New York bank, the transaction is fundamentally the same. In both instances an American bank pays out dollars; there is in each case an offering of pounds against dollars.

When a free exchange market existed it was sometimes wondered why rates between pounds and dollars were always practically the same in London as they were in New York. If in New York the rate for pounds fell from $4.95 to $4.90, the rate in London moved in the same manner at the same time, so that the two rates were always practically identical. The reason for the similarity in rates between New York and London was that these cities were in reality two parts of the same market.

Assume that the rates were different, that the rate in New York was $4.90 while that in London was $5.00. Americans could then purchase a cable draft for $4.90 and with the pounds proceeds immediately buy in London a cable draft on New York yielding $5.00. This would mean making 10 cents on each pound less minor expenses. It would be a handsome profit with almost no risk. Such transactions would require only a few moments to be completed, and would create so strong a demand in New York for pounds that the rate there would rise from $4.90 toward $5.00. In London the strong demand for dollars would tend to raise their price from $5.00 toward $4.90 per pound. These forces would continue until the rates in the two centers became so close that the profit disappeared. If the rates became separated by only a fraction of a point, transactions such as the above, arbitrage transactions as they are called, would take place and quickly tend to bring the rates together.

As a result of exchange restrictions such transactions are less feasible, but rates in London and New York are nevertheless practically the same for most transactions. United States owners of pounds received as payment for exports to England can obtain in London a definite number of dollars for the pounds. This fixes a lower limit on their price in New York. On the other hand the United States owners cannot obtain more since an ample supply of pounds exists at this price.

Large sums are transferred constantly between the various parts of the world by means of telegraph. If a person in New York desires to make immediate payment to a person or corporation in London, he pays dollars to his bank in New York, which cables its correspondent in London to pay pounds to whomsoever he has designated as the recipient. A London ex-

porter having received a cable transfer from New York proceeds with the shipment of goods. He perhaps receives payment from the London bank against delivery to it of shipping documents, which are then forwarded to the New York importer. This would be a cash transaction and is not the customary procedure.

Cable transfers of this kind are used extensively. An American importer may have agreed to place a London bank in possession of pounds on a certain day to cover a draft drawn on the bank by the British exporter, accepted by the London bank, and which is now coming due. The American thereupon buys a cable transfer to cover the draft. An American importer may find a cable transfer the most economical method of making payment to a London exporter. A cable does not require that he provide any money until the day the payment is due; whereas if he purchased a demand draft and sent it to London, he would have had to part with his money several days earlier, perhaps borrowing it from an American bank and paying interest. The demand or sight draft would have cost a little less than the cable. A slight spread may therefore exist between a cable or spot rate of exchange and the demand or sight rate. With the development of fast air transportation this spread has narrowed or disappeared entirely.

The slightly greater cost of a cable transfer over a demand bill or over a time bill is because of the time element and interest involved. If a bank sells a demand bill, no money has to be paid on it while it is in transit and until it is presented; a cable must be paid immediately. In the case of a demand bill, the bank thus has the use of the money for a longer period than if it sells a cable. For similar reasons a sixty-day bill is cheaper than a demand bill, and a ninety-day bill is cheaper than a sixty-day bill.[3]

Arbitrage Transactions.—When exchange markets were free, information on rates in other centers made possible what are known as arbitrage transactions, that is the purchase of a foreign currency via a third or fourth country, or the purchase

[3] A code of standard practices and procedures with respect to trade and exchange controls was adopted by the parties to the General Agreement on Tariffs and Trade (GATT) at their meeting in Torquay late in 1950. Observance of the code is not compulsory. See Chapter 20.

of our own currency via a foreign country. Such transactions tended to keep the rates in all centers in line with each other. An arbitrage transaction involves buying a draft on a foreign country, which is used there to buy in turn another draft on either the original or a different foreign country. For example, assume that in New York a strong demand existed for pounds, so that the rate on London was high. At the same time the foreign exchange banker would notice that perhaps francs were cheap in New York, and that in Paris pounds were cheap in terms of francs. In order to buy pounds, he thereupon purchased francs and instructed his Paris correspondent to buy pounds with the francs. In New York he could immediately sell a pound draft against the francs purchased to acquire sterling. The transaction of buying sterling via Paris might also include other centers. If the rate in New York on London were even slightly out of line with the rate in London on New York, New York bankers, as noted above, would buy pounds and promptly use the pounds to buy in London drafts on New York. Inasmuch as most exchange rates are now rigidly fixed and since exchange purchases are subject to license, fewer opportunities exist for arbitrage operations. From the standpoint of the New York market the rate in Paris on London in its relation to the New York-London rate is referred to as the franc cross rate.[4] An arbitrage transaction through a third country, it will be noted, requires that the cross rate be somewhat out of line, otherwise there is no profit in the transaction.

Risk of Exchange; Forward Exchange.—In trade with countries that have fluctuating rates of exchange exporters and importers frequently endeavor to eliminate the risk that comes from such fluctuations. For example, an exporter who is to receive 10,000 pesos ninety days from date may not know what these pesos will yield him in dollars at that time. He, therefore, arranges now as to the conversion of these future pesos into a fixed number of dollars.

When an exporter draws a draft in his own currency, the exchange risk is, of course, with the importer, who then must

[4] See the discussion of cross rates in Chapter 22.

buy a draft on the exporter's country to cover the draft drawn by the exporter. When an exporter agrees that the draft be in a foreign currency, he then either bears the exchange risk himself, or must arrange to avoid it. If he wishes to avoid this risk, he can make what is called a future contract, that is, arrange with his bank ahead of time as to the price the bank will pay for the kind of draft he is to draw. He then knows exactly what he will receive in his own kind of money for the draft he will have to sell. This is called "fixing exchange forward."

Exporters, especially in the United States, often insist that the letter of credit be drawn in the currency of their own country, so as to eliminate the exchange risk. American exporters commonly quote prices in terms of dollars, and specify dollar payment, while English exporters, especially to the so-called sterling area, commonly insist upon payment in pounds, unless, due to the scarcity of dollars, they can obtain dollars. If an American exporter asks that the letter of credit be in dollars, he probably draws his bill not on the foreign bank opening the credit but on the confirming bank in the United States.

When a bank buys or agrees to buy a draft in a foreign currency, if it does not wish to take a position in the currency in question, it will immediately sell an equal amount of exchange in the same currency, so as to cover the draft it has purchased. For example, the exporter may sell to his bank a draft for 10,000 francs due ninety days from date. At the same time an American importer of French goods knows that in ninety days he must buy a draft for 10,000 francs to cover a shipment he is receiving. He may feel uncertain as to the precise amount the draft will cost him. To avoid risk, he arranges with his bank now as to the price to be paid. The bank thus arranges to sell him the francs it buys from the American exporter. The bank has covered a purchase with a sale and assumes no risk of exchange. The maturities of the drafts are not of vital importance in hedging operations of this kind. The sale of a demand draft by a bank can be covered by the purchase of a sixty- or ninety-day draft.

Speculators who think the price of a foreign currency is too low and that a rise in the rate is due may buy that currency with

the hope of reselling at a profit later. Or if they think it too high, they may sell it short, expecting to cover their sale by a subsequent purchase at a lower price. Speculators deliberately assume a risk which most foreign traders are glad to avoid.

Foreign Exchange Market.—Without the facilities provided by international money markets, world trade would be greatly handicapped. That part of the money market that is immediately concerned with the purchase and sale of bills of exchange constitutes what is commonly known as the **foreign** exchange market. The most important institutions which make up the foreign exchange market in New York are the large commercial banks and the foreign exchange brokerage firms. Private international banking houses formerly held a dominant position in the exchange market. These houses, which were usually partnerships with long-established reputations, have been overshadowed by the commercial banks, and the volume of their business is at present not large.

The foreign departments of the more important commercial banks now handle most of this country's foreign exchange business. These banks have numerous correspondents and branch offices at home and abroad. A large part of their business is the sale of telegraphic transfers and drafts drawn on their foreign correspondents; they also buy bills of exchange from exporters. The foreign drafts which they buy are sent to the proper correspondents, and the proceeds credited to the banks' foreign deposits or are converted into dollars. Foreign deposits, or balances held abroad, enable the foreign exchange department to sell its own drafts in the desired amounts, drawn on the foreign bank and payable to a designated payee. Banks today, however, endeavor to avoid maintaining large balances in foreign currencies, except perhaps in pounds sterling. Instead of assuming the risks of currency depreciation by maintaining such balances they draw on their foreign correspondents as needed, with the request that the correspondents reimburse themselves by drawing in dollars against the United States bank.

As a result of international currency uncertainties during the

past decade or two and the decline in the widespread use of the pound sterling in international trade most United States foreign trade has come to be invoiced in dollars. Consequently the volume of foreign bills bought by United States banks and dealers is relatively small. The bulk of foreign exchange business today consists of trading in telegraphic transfers and to a lesser extent in air-mail transfers. The former extensive practice whereby foreign banks drew on their United States correspondents in order to create dollar exchange is similarly almost nonexistent today.

The foreign exchange broker, like the foreign exchange department of a bank, assumes the function of bringing together buyers and sellers of foreign bills. By being constantly in touch with buyers and sellers of all types of exchange, he may save his clients money. Since there is no central gathering place in New York, analogous to the stock exchange, where foreign bills can be bought and sold, dealings with brokers are conducted almost entirely by telephone. Exchange brokers have private wires leading to the offices of the commercial banks, international banking houses, foreign-investment houses, and other buyers and sellers of exchange. It is this close intercommunication which in normal times keeps rates similar and the market unified.

Drafts, or bills, drawn by exporters are usually drawn not on the importer but, through letter of credit arrangements, on a bank which has agreed to act for the importer, as previously noted. These drafts are usually sight drafts and are thus commonly paid without becoming acceptances. Time drafts are, of course, accepted and have maturities ranging from thirty to ninety days. These accepted bills, bankers' acceptances if accepted by a bank, are the pieces of paper bought and sold by the discount houses. They form a safe short-term investment, but under present conditions are rather scarce.

When the bills are sold in the discount market and held there to maturity, it is the discount market that provides the money which is paid to the exporter as soon as he has shipped his goods and sold his bill. The bank buys the exporter's bill from him for cash, and then may turn around and sell the bill in the

discount market, directly or indirectly, thereby reimbursing itself. Thus the discount market helps to finance the exporter.

Banking Facilities; Foreign Correspondents and Branches.—The conduct of foreign trade centers around banks and related institutions. In order to conduct their foreign business, banks either maintain their own branches abroad or deal with banks already established there. Foreign banks with which working arrangements are maintained are known as correspondent banks. A foreign branch is an integral part of the domestic institution, or is a wholly or partially owned affiliate, whereas a correspondent is a separate institution which performs certain services for the domestic bank.

British banks maintain numerous branches in Great Britain, and a certain number of branches in foreign countries. Great Britain has long relied, however, in the international field largely on foreign correspondents, on affiliated institutions, and British-owned overseas banks which usually maintain their head offices in London. Banks in the United States have also depended on correspondents much more than on foreign branches, although there are in foreign countries a large number of branches of American banks.[5] Most American banks until recent years have been prevented by law from having branches even within the United States. It is thus logical that American banks should have turned to foreign correspondents. Only since 1914 have American banks, with a few exceptions, established foreign branches. Prior to the Federal Reserve Act of 1913, national banks were not allowed to have branches, so that American banks with branches abroad in 1913 were mainly trust companies and private banking institutions.

International Financial Centers.—Foreign trade is ordinarily financed through one of the large international financial centers, particularly New York and London, and to a lesser extent several other cities, Paris, Brussels, Amsterdam, San Francisco, etc. The facilities which a financial center offers

[5] American banks which maintain branch banks abroad are the National City Bank, the Bank of America, the Chase National Bank, the First National Bank of Boston, and the Guaranty Trust Company of New York.

include banks with connections throughout foreign countries, and a broad discount market where foreign bills of exchange may be discounted. A discount market provides the owner of a time bill a ready market where the bill can be sold or discounted, and is a necessary part of the machinery for financing foreign trade. The purchasers of bank acceptances and trade acceptances find them attractive since they are highly liquid investments in the sense that they can be sold at any time should the holder desire cash. The buyer pays less than the face value and receives interest by holding them to maturity.

The discount rate formerly affected the choice of a center through which trade was financed, but under present conditions other factors are more important. An exporter's draft, when sold after acceptance, is discounted at the prevailing rate of interest on acceptances, that is the amount of interest for the period before maturity is deducted from the face value of the bill. If the acceptance rate is lower in one center than in another this fact favors financing through the center with the lower rate, other things being equal. When the currency of a financial center, however, is not freely convertible into that of the exporter he may not wish to receive such currency, and the financing may be arranged elsewhere. When currencies were freely convertible traders had a wide choice as to financial centers.

The New York discount market dates from the establishment of the Federal Reserve System in 1914. Not until after the first World War did it become a significant part of the New York money market. Prior to 1914 most American banks were not allowed by law to accept time drafts;[6] consequently a discount market could not exist. The dollar at that time was little used in foreign trade and New York was not an international financial center in a genuine sense. New York came to the fore rapidly after the first World War when European currencies were depreciated and unstable, and when the dollar was practically the only reliable gold standard unit. The position of the dollar was strengthened further by the second World War and events growing out of the war. The world has come to recog-

[6] The "illegality" has been subject to some question.

nize the United States as economically and politically strong and has confidence in its currency. The intense postwar demand for American goods and for dollars with which to buy these goods strengthened the international position of the dollar.

New York and London are the two outstanding financial centers. Both have large financial institutions equipped with extensive facilities for financing foreign trade. They both have a broad discount market and relatively low rates of discount, which means that large sums of money are available to buy bills and hold them to maturity and thereby receive the interest for the period. The pound and the dollar are currencies known all over the world and are often used in transactions between countries other than the United States or Great Britain. Banks everywhere that do much foreign exchange business maintain balances in New York and London and are always ready to buy or sell these currencies.

Since the dollar is freely convertible a draft on New York is acceptable anywhere. The inconvertibility of the pound sterling has limited its acceptability and hampered the international financial position of London and its activities as banker to much of the world. The pound, however, is readily accepted throughout the sterling area.

Silver Exchanges.—Since China abandoned the silver standard in November, 1935, this standard no longer exists in any large nation. Exchange rates upon silver standard countries, therefore, have principally only historical interest. The silver standard, however, has had a long and significant history. Between two silver standard countries exchange rates would be determined by the same principles that determined rates between two gold standard countries.

Between a gold standard and a silver standard country, exchange rates would tend to be fixed by the price of silver, that is, the price of silver in terms of gold money. Thus, if silver could be bought in New York for 70 cents an ounce, and this silver when shipped to China could be turned into Chinese money at the rate of about 1.25 Chinese dollars per ounce, current exchange rates on Shanghai would be limited by the possibility of

buying silver and exporting it to China. Rates on Shanghai, therefore, could not rise much above the point fixed by the price of silver in New York.

On the other hand, since Chinese silver could be brought to America and sold, rates on Shanghai could not fall below the amount of American money yielded by the importation of Chinese silver. A person in the United States wishing to buy Chinese dollars could always buy silver and export it. Similarly, a person in the United States wishing to sell a Chinese draft could always import silver from China and sell it in America if market exchange rates were out of line with the price of silver.

For example, if a Chinese importer of American piece goods desired to purchase a draft on New York and thought the price of United States dollars too high, he might, if he wished, ship silver to the United States, and sell the silver as bullion. The metal which he shipped would, in the United States, be merely a commodity and would yield a varying amount of United States dollars depending upon the price of silver. Bullion shipments are ordinarily undertaken by banks rather than by individuals. It can be seen that between gold standard and silver standard countries exchange rates had no fixed relationship but fluctuated around a point determined by the price of silver.

Exchange rates between a silver standard country and countries with inconvertible currencies would be determined not very differently from those above. The possibility of shipping silver between these countries would still limit the rates, but the price of silver to be considered would be, not the price in terms of gold, but in terms of the inconvertible currency. The position of silver in international finance is discussed in Chapter 26.

PART II

THEORETICAL ANALYSIS

Chapter 6

MONEY, PRICES, AND THE RATE OF EXCHANGE

Independent Currency Systems.—As noted in the previous chapter the world has approximately as many currency units and systems as it has countries. The International Monetary Fund publishes rates of exchange for over sixty different currencies, omitting rates for several of the smaller countries. In Europe there are today some twenty different currency units. Prior to the first World War there were in Europe only half that number of really distinct units, the smaller number in 1913 being due not only to the fewer countries but to the existence of currency unions. In the currency unions the monetary units were for practical purposes identical and were freely exchangeable one for the other.

As a result of the Latin Monetary Union, France, Belgium, Italy, and Switzerland had currency systems based upon a gold unit worth 19.29 cents in United States money. The unit was called a lira in Italy and a franc in the three other countries. The denominations and sizes of the coins were alike, but the insignia differed. The money of each country circulated freely in all of the other countries in the Union, although each of these countries had its own issuing authority and individual monetary system wherein the supply of money changed according to national conditions and measures. Similarly, as a result of the Scandinavian Monetary Union, the three Scandinavian countries had identical units which circulated interchangeably in each of these countries. These monetary unions broke down as a result of the first World War.

The fact that so many currency units exist in the world today gives rise to a number of problems and retards the expansion of

trade and production. Difficulties having to do with currency relations between countries center around the inability to transfer funds freely from one currency into another, and fluctuations in the rate of exchange between the currencies, or uncertainties as to possible rate changes.

Trade and financial transactions between countries have become larger and larger as the world's economic affairs have become increasingly interwoven and interdependent. The existence of a variety of independent currency units and systems accompanied often by lack of free convertibility from one into another, as well as by uncertainties as to exchange rates, has handicapped the trend toward economic integration and expansion. It has retarded the investment of capital and economic development.

The possibilities of regional currency unification have for a long time intrigued students of international affairs, but such plans are confronted by rather formidable obstacles. Countries are not yet prepared to relinquish to an international authority the exercise of the necessary broad financial powers. A merging of currency systems means merging to a considerable extent fiscal systems and financial administrations. Countries have thus far been reluctant to move very far in this direction.

Since no international currency unit exists, trade must select the unit of some particular country in terms of which transactions can take place. The United States dollar and the British pound sterling are the commonest units for foreign trade transactions and together account for well over half of the world's trade. Regardless of the unit used, in every transaction either the importer must acquire the exporter's currency in order to make payment to him, or the exporter must receive the importer's currency or perhaps some other foreign currency, and convert it into that of his own country. The exporter in special cases may be willing to hold a currency other than his own for an extended period of time, or may be willing to receive it because he is able to expend it elsewhere; but ordinarily he desires to convert receipts promptly into his own money. This means that he is constantly confronted with the problem of foreign exchange.

Internal monetary movements in a country affect its foreign exchange and balance of payments position, as well as economic conditions in other countries. The effects of monetary expansion, for example, are felt in many countries as the inflating country with enlarged monetary incomes endeavors to buy more abroad, and as its export commodities become higher in price both at home and abroad. The utilization of such a country's gold or foreign exchange reserves to pay for the enlarged imports and to offset the loss of exchange receipts as a result of a reduction in exports may also have repercussions in several countries. A shift in the rate of exchange, which may be necessitated by the inflation and balance of payments deficits, will affect the trade and balance of payments of a large number of other countries. The international ramifications of domestic monetary policies and monetary movements are extensive.

Value of Money.[1]—Prior to the changes in economic thinking which took place during the 1930's (to a large extent as a result of the writings of John Maynard Keynes), the value of money was generally explained in terms of the Quantity Theory of Money. While the theory is now considered inadequate in its rigid form, there is nonetheless considerable truth in its basic tenets, particularly if the analysis is adapted to current economic thinking and conditions. It is a good starting point for analysis of the forces which determine the value of money.

The Quantity Theory of Money taught that the value or purchasing power of money (as indicated by the average or level of all prices) was determined on the one hand by the amount of money in a country and the rate at which it was spent, which was referred to as its velocity of circulation, and on the other hand by the volume of trade, or more precisely, the volume of transactions requiring the use of money. It followed that the larger the quantity of money in relation to the volume of transactions the less value would attach to each piece of money. An expansion of the money supply would therefore mean a rise in

[1] The following discussion of the forces which determine the value of money is in condensed form, and is for the purpose of providing background for consideration of the theoretical aspects of the rate of exchange and other subjects.

prices unless there was a corresponding increase in the physical volume of goods traded or in other transactions requiring money. The factors involved were set forth in the Equation of Exchange developed by Irving Fisher wherein M represents the money supply, V the velocity of circulation, P prices, and T transactions. The equation is $MV = PT$.

It was said that if the amount of money in a country were doubled, "other things remaining equal," prices would also double. It was noted, however, that prices did not always move in a precise ratio with the quantity of money. The explanation offered was that "other things" had not remained equal and that changes in the velocity of circulation, V, or in the volume of transactions, T, had taken place. If money circulated more rapidly the result was observed to be the same as though the quantity were increased, whereas if money were held idle and not spent the effect was that of a reduction in the quantity. The theory said, without attempting to analyze carefully why money was sometimes spent and was sometimes held and not spent, that if the velocity of circulation slowed down the effect would be a reduction in prices, since money that was idle could exert no influence. The velocity of circulation was regarded as a factor that in a sense determined its own rate, rather than as merely a numerical figure which required explanation and which reflected the preferences and decisions of individuals with respect to saving and spending.

The monetary supply was properly held to include bank deposits subject to check since in most countries such deposits represent the major portion of the circulating medium. The amount of bank deposits, furthermore, in the rigid interpretation of the theory, was held to depend upon the amount of gold, in a gold standard country, since it was argued that such deposits were limited by the size of the gold reserve and always tended to seek the maximum limit.

While the Quantity Theory of Money in its narrow form involved certain false assumptions and did not provide a complete explanation of the price level, it did contain important truths. It performed a valuable service in its emphasis on the relationship, although not fully understood, between the amount of

money and the level of prices. In earlier periods governments had frequently been unaware of this relationship and had inflated the money supply and wondered why the value of the money depreciated. David Ricardo, writing in the early part of the last century, however, pointed out that the quantity of money had an important relationship to its value when he said:

> . . . by limiting the quantity of coin, it can be raised to any conceivable value.
>
> It is on this principle that paper money circulates. . . . Though it has no intrinsic value, yet, by limiting its quantity, its value in exchange is as great as an equal denomination of coin or of bullion. . . .
>
> On these principles it will be seen that it is not necessary that paper money should be payable in specie to secure its value; it is only necessary that its quantity should be regulated. . . .[2]

The value of any article, including money, is the result of numerous factors that are reflected in the interplay of demand and supply forces. In order to understand how this value is determined and why it changes from time to time it is necessary to analyze these demand and supply forces. In the case of money the supply (*M* in the above equation) consists of all money in the hands of the public, that is, outside the banking system, and all demand deposits which are subject to check and which can therefore be spent the same as physical currency.

The magnitude of the monetary supply (although determined in part by the demand for money) is largely the accumulative result of fiscal and monetary policies of the government over the years. In nearly all countries the supply of money has tended continually to increase as governments have needed funds over and above sums received from taxation. When governments borrow, the money supply is usually expanded and so continues as long as the debt is outstanding. When governments borrow their debt obligations are commonly sold to banks, the government receiving a bank deposit in return which is created simultaneously by the banks. Similarly, when private individuals or businesses borrow from banks they receive, in

[2] David Ricardo, *On the Principles of Political Economy and Taxation* (1st American ed., 1819), Ch. XXV.

return for a promise to pay, a deposit which is thereby brought into existence and which can be drawn against. As banks lend they thus expand their deposits, which are an important part of the money supply. When banks buy government bonds or other obligations they thereby increase deposits by paying for these with a deposit credit.

If the public desires to draw out deposits in currency additional paper money is supplied to the banks under arrangements that differ from country to country but which usually are administered by the central bank and which involve the sale of bank assets to the central bank for cash. New money is printed as the central bank needs it. Banks are able to convert certain assets into cash or into a reserve deposit at the central bank which can be drawn out in cash.

The central bank, which is a government or semigovernment institution, usually holds a large part of the cash reserves of the commercial banks. It also usually holds all or a large amount of whatever gold and foreign-exchange reserves the country possesses. It supplies cash to the commercial banks by extending them loans or buying certain kinds of their assets. The interest rate which it charges, together with the exercise of regulatory powers assigned to it, enables the central bank to control within limits the lending operations of the other banks and thereby to influence the expansion or contraction of the monetary supply. If gold is flowing into the country and expanding the currency, or if due to large exports foreign exchange is being received and sold to the bank in exchange for local money, also expanding the currency, the central bank, in order to counteract this expansion, may raise the interest rates it charges the commercial banks and otherwise discourage bank lending. It may also sell some of its securities directly in the open market and hold idle or withdraw from circulation the money received. The absorption of money from circulation by such sales reduces the resources of commercial banks and may force them to borrow from the central bank, paying the higher rate of interest, or to contract their loans to borrowers. Through these and other devices the central bank can influence the monetary supply of the country.

Changes in the supply of money ordinarily come about as a result of events outlined above, particularly government and private borrowing or repayment of debt, and changes in exports and imports. These movements take place largely independently of the demand for money and of price movements, but not entirely so. For example, a higher price level may induce more borrowing.

The Quantity Theory of Money made these basic monetary and price relationships clear, but it tended to overemphasize the function of monetary supply as the determinant of prices and to overlook certain other important movements. It assumed that other factors affecting the value of money followed an even course without much change unless influenced by changes in the money supply. It taught that price level changes originated, with some exceptions, in changes in the money supply, which is to a large extent the case but not to the extent assumed by the theory in its rigid form.

It also assumed that an increase in the amount of money was regularly followed by an increase in spending and that this spending resulted in a rise in prices; vice versa with respect to a decrease in the supply of money. It largely overlooked the effect of the new money upon production and employment, and assumed that these were unaffected by monetary movements. However, if new money is spent, and it usually is, the effect may be an expansion of output and employment with little or no rise in prices. If unused productive capacity, resources, and labor exist the effect of new spending is to increase output. As full employment is approached and bottlenecks appear the effect of the spending on prices becomes more pronounced. The new money, however, may not be spent but may be saved, in which case it has no stimulating effect upon production nor does it raise prices. It is important therefore to understand the conditions under which money is spent or not spent; also whether it is spent for consumption or invested in capital goods.

The rate of spending of money is reflected in V in the equation; it is sometimes described in terms of the demand for money as money. The demand for money is determined by such things as the amount of goods bought and sold or other

transactions consummated by money, T in the equation (the size of T results from the size of the population, its productivity and industrial advancement, the nature of the economy, etc.), by the average amount of pocket money individuals carry to meet their personal needs (the more they carry the greater is their demand for money and the slower the turnover), the amount they hold on the average in the bank (this depends on the interval between pay periods, their savings habits, etc.), the amount businesses customarily hold either in the till or in the bank in order to transact their business, the extent of business integration wherein the various processes of production are carried out by a single firm so that less money is needed, and the state of business and investment including prospects for the future. The degree of liquidity, that is the extent of the cash balances which people or businesses maintain in response to various conditions, changes from time to time.

As money is spent and respent it passes from consumers to retailers, to wholesalers to producers, etc., eventually getting into the hands of consumers again. At each step part of the money is paid out as wages and salaries and thereby takes the form of income, while part of it is passed along as payment for a business cost. The length of time necessary for money to complete this circuit from one income recipient to another income recipient is called the circular or income velocity of money. It refers to the number of times during a given period a unit of money on the average is received as income. It has been estimated that in the United States approximately ten dollars worth of unfinished output is exchanged for every dollar's worth that is bought by the recipients of income. Changes in the income velocity of money usually take place slowly and within fairly definite limits. The income velocity of money in the United States has tended to slow down during the past two decades.

When new money is added, whether as a result of bank lending, government fiscal operations or imports of gold, or when hoarded money becomes active, and is spent and respent it increases monetary incomes. The new money ordinarily increases incomes several times its original amount, the number

of times being known as the multiplier. The amount of these incomes that is spent on consumption, the amount that is saved as idle money, and the amount that is invested have an important bearing upon economic activity, output, employment, and prices. If a country has considerable unemployed resources and labor the new money may expand output with little effect upon prices, whereas if there is little unemployment of labor or of resources an increase in money may result in higher prices.

It can be seen that the value of money is not the result of a simple relation between the quantity of money and the volume of transactions. This relationship is subject to forces which do not move in a mechanical manner. Attempts to supply figures for the Equation of Exchange have not met with much success, largely because T represents a mixture of various kinds of transactions for which adequate numerical figures do not exist nor can they easily be compiled. For this and other reasons monetary analysis has followed an approach in which special attention is focused upon income velocity and the effect of spending on consumption, on the national income, and employment. In this analysis the quantity of money and changes therein occupy a central position as in earlier thinking. While it is recognized that an increase in the money supply does not necessarily result in a rise in prices there is usually a strong tendency in that direction.

In monetary and price analysis it is important to recognize that the forces outlined above are not free to work themselves out in an uninhibited fashion. Economies today are subjected to a greater or less degree of government regulation in the interests of various economic and social objectives. Prices of many articles are fixed by governmental order, in which case the supply of the article is usually less than the amount that could be sold at the fixed price. Because less money need be spent for such an article more money is available for other purposes. Governments may influence prices indirectly by subsidies or other devices. Minimum wage laws, restrictions on imports, health and safety regulations, taxation including that to limit consumption, fiscal policies, regulations on business practices and on employment, together with numerous other

regulatory measures, affect in an important manner monetary and price movements. The extent of government regulation of economic life varies from country to country, but in practically all countries the free economic system of the nineteenth century is far removed from that which prevails today. Nevertheless, the forces described above are still operating and are powerful influences. Their effects are modified according to the extent and nature of government regulation.

Factors Determining Rate of Exchange.—It was noted above that the rate of exchange which prevails in a free market is the rate which will equilibrate the demand and supply of foreign bills. It is the rate which will clear the market. Such a statement, however, does not explain very much. It is necessary to know why the demand and supply of bills are what they are and why they change. A list of the sources of supply of foreign bills includes exports of merchandise; services rendered to foreigners, such as shipping and insurance services; the transfer of funds to this country from the foreign country; and a variety of other transactions which result in an offering of foreign currency for local currency. The sources of demand for foreign bills include imports of merchandise, services received which must be paid for, the transfer of funds to a foreign country, and a variety of other transactions which cause persons or businesses to offer local currency in exchange for foreign currency.

A complete explanation of the factors which determine the rate of exchange in a free market requires much more than a listing of sources of demand and supply. It requires analysis of such matters as the conditions which cause goods to be imported rather than to be produced at home (if produced at home there is no demand for foreign exchange), the conditions which cause goods to be exported, and, in fact, the gamut of conditions and influences which account for all of the foreign trade and financial transactions of a country—why they take place and why their amount is what it is. Such an analysis covers the entire field of international economic theory, considered in subsequent chapters. For present purposes it is sufficient to note

that the factors of production are distributed unevenly throughout the world, and that in some countries land is in large supply as compared to labor and capital equipment, whereas elsewhere labor is relatively abundant and cheap, or, as in the United States, capital equipment is more abundant in relation to labor. As a result of these differences in the ratios of the factors of production some commodities can be produced in certain areas more easily than elsewhere. Grain, for example, can be produced economically in regions where good land is plentiful. Consequently, production becomes specialized and trade of certain commodities between different regions is profitable. The same principle holds whether the trade is domestic or foreign. In this trade the ratios at which the different kinds of goods customarily trade depend basically upon the desires of the consuming public and the difficulties of producing the different goods. If the public wants an article producers will ordinarily provide it, entailing the necessary costs. These costs may be low, in which case the article is plentiful and cheap. Or the costs may be high, in which case it is scarce and expensive. The kinds of goods produced, the amount of each, and the costs entailed in production are adjusted to the desires of consumers as expressed in the market where goods are traded. The ratios at which goods trade reflect all of these conditions and change from time to time depending on crop conditions, technological improvements, changes in consumers' desires, etc.

The ratios at which goods trade are indicated by their prices. Whether a commodity is bought at home or abroad depends upon the price of the foreign commodity in comparison to the price of the similar domestic commodity. The cost to us of the foreign commodity, however, depends also upon the rate of exchange which determines the amount of local money to be given to acquire the foreign money. The price and the rate of exchange together determine whether the foreign commodity is cheaper than the domestic commodity.

The rate of exchange, however, is itself influenced by whether the foreign article is bought and by how much of it is bought, inasmuch as demand for the foreign currency affects the rate in a free market. Importation of the article creates a demand

for bills on the exporting country and thereby tends to raise the rate of exchange. Movements in the rate affect the cheapness or dearness of the imported article and help to determine whether it is imported, and if so, the amount, while at the same time these importations or their absence help to determine the level of the rate. The rate which emerges is said to be an equilibrium rate in that it equilibrates the demand and the supply of bills at that time.

It may happen that a considerable change in rate is necessary to cause the market to absorb an increased offering of a country's currency, resulting perhaps from increased imports by that country. The price elasticity of demand for the goods of that country in other countries may be low so that increased purchases of its goods are not made unless their cost becomes considerably less. In order that these goods may become sufficiently cheap to foreigners that the country's exports will increase substantially and the supply of its bills in foreign markets be absorbed, exchange rates may need to decline materially. A lower rate (more expensive foreign currencies) also discourages imports into that country since foreign currencies, and therefore goods, cost more. The domestic demand for foreign goods may be sharply curtailed, or the demand may be well maintained even at the higher cost. Also, the currency of such a country, received by other countries as proceeds from the sale of exports to it, yields the other countries less in local currency at the lower exchange rate. Foreign suppliers may reduce their offerings considerably, or perhaps not very greatly.

It is to be noted that the elasticities of demand and supply which affect exchange rates and which influence the extent of a rate adjustment needed to bring sizable changes in exports and imports are as follows: (*a*) the elasticity of a country's demand for imports, (*b*) the elasticity of its supply of exports, (*c*) the elasticity of foreign demand for its exports, and (*d*) the elasticity of the foreign supply of exports to the country. These elasticities together determine whether a change in the rate of exchange is followed by large or small changes in exports and imports, and, as noted below, the effects upon the terms of trade.

The interplay of these demand and supply forces in a free

market brings an equilibrium, even though it is a constantly changing equilibrium. Since the many forces which are involved in an equilibrium situation are changing, rates tend to fluctuate while seeking a new equilibrium level. If a country, for example, inflates its currency, monetary incomes there tend to expand and the purchases of both domestic and foreign goods to increase. The rate for foreign currencies rises as these currencies are demanded in order to pay for the increased imports. Exchange movements may stimulate or discourage certain trade, but as this trade consequently expands or contracts it, in turn, alters exchange rates in a free market and tends to promote equilibrium.

Speculation is also a cause of short-term rate movements. While speculators may cause wide fluctuations in the rate, they have little effect upon the longer term average. Their purchases and sales tend over a period of time to cancel each other but in the meantime may be responsible for considerable instability.

It can be seen that the forces which are concentrated on the market rate of exchange and which help to determine its level and movements are numerous. An equilibrium rate is merely a rate that equilibrates; it is the result of forces that act and react upon each other. The present discussion gives only a general indication of the nature of an equilibrium rate and of the forces behind it. More will be said on this subject later.

Most countries do not have a freely moving exchange rate, a floating rate as it is called, except perhaps in a black market. Governments establish and maintain fixed rates which may or may not be close to what would be an equilibrium rate. Under the gold standard the rate could not move far from the par value because buyers of a currency were able to export gold rather than pay much of a premium and sellers could import gold rather than accept much of a discount for a currency. If the rate did not clear the market, gold shipments took care of any differences. After the abandonment of free gold shipments and their stabilizing influence governments undertook to maintain fixed rates by regulations over the buying and selling of foreign currencies. These regulations usually included require-

ments that all exchange be sold to a central agency. Since at the fixed official rate, and with no possibility of free gold shipments, there was usually an unsatisfied demand for foreign exchange, it became necessary to allocate the available exchange to those needs which were considered most essential. Exchange could be purchased only under a license. The determination of an exchange rate under a system of exchange control and fixed rates is a matter of governmental decision. The considerations entering into such a determination, whether the question is a continuation of an existing rate or the selection of a new rate, involve both political and economic factors. The consequences of maintenance of a rate which departs widely from what would be an equilibrium rate are discussed below.

Overvaluation and Undervaluation; Purchasing Power Parities.—The purchasing power of a currency over goods and services within the country is an important factor in the foreign demand for such currency. Importers are very much interested in the prices prevailing in countries in which they buy, or in other words in the purchasing powers of the currencies of such countries. If prices within a country rise the costs of its goods to foreigners are higher and its exports tend to decline. If we assume that prices in other countries have not also risen, foreign goods become relatively cheaper to such a country and imports increase. The higher monetary incomes and prosperity in such a country of higher prices also lead to increased imports. Its currency, which will buy fewer goods, is in less demand and in increased supply abroad, unless the rate of exchange on the country falls to compensate for the increased prices of its goods. In such a country foreign currencies are in strong demand in order to pay for the increased imports, but the supply of foreign currencies is less because of reduced exports.

Under these circumstances a freely moving rate of exchange will fall until it adjusts to the new demand and supply situation and reflects the lower internal value of the currency. It will seek a level which enables the country's exporters to compete in the world market, and which brings a balanced relationship between the country's prices and those abroad. The internal price level or purchasing power of a currency is therefore an important

factor in the determination of the equilibrium rate of exchange. Its influence on the rate is exerted through the demand and supply of bills in the exchange market.

Under a program of fixed exchange rates the inability of the rate to adjust to price changes in the different countries may mean that the rate either overvalues or undervalues a currency on the basis of relative prices and costs. Such overvaluation or undervaluation conduces to an unbalanced condition in the country's foreign trade and international accounts.

The relationship between the purchasing power of two currencies has been called the purchasing power parity.[3] While it is difficult to make an absolute comparison between the purchasing powers of two currencies because of differences in the kinds and qualities of goods, many of which are purely local and do not move in international trade (such as houses, personal services and perishable commodities), we may nevertheless calculate what might be considered a more or less representative relationship or parity as a starting point. We might say, for example, that in a certain year the pound sterling would buy approximately four times as much as the dollar, and that the purchasing power parity of the pound that year might be considered $4. If prices in the United States were to fall so that the dollar would buy more, whereas prices in Great Britain were to remain unchanged, the purchasing power parity would be perhaps, $3.50, since fewer dollars would be needed to buy the same amount of goods. If the index of prices in the United States, however, showed no change, whereas the British price level fell, the purchasing power parity might be $4.50. If both price levels moved in the same direction and in the same proportion the purchasing power parity would remain unchanged.

In calculating purchasing power parities it is customary to take as a base a year (or several years) in which the international accounts of the country appeared to be in reasonable balance, and to consider that the exchange rate which prevailed at that time reflected the purchasing power relationship of the currencies. It is necessary to have such a base in order to compare price movements, but it is not easy to find a base that is

[3] See Chapter 16 for further discussion of this subject.

genuinely representative and that reflects what would be a stable relationship if the disturbing factors were eliminated. Even though the base is not entirely representative little harm is done if attention is directed to the changes which take place in prices in the two countries in subsequent periods rather than to the original absolute relationship.

If the currency of a country is undervalued in the exchange market in that its internal purchasing power is relatively high to foreigners, that is prices to foreigners are low because of the low exchange rates, the country becomes a country of relatively low costs and its exporters tend to sell more abroad. Increased purchases in such a country by foreigners create a demand for its currency and tend to raise the exchange rate until it becomes in approximate balance with the internal value of the currency. The demand and supply of bills in this manner tend to bring rates of exchange in a free market to a point that represents a balanced relationship between the internal purchasing powers of the currencies bought and sold. Exchange rates and purchasing power parities tend to come together, apart from long-term influences independent of prices which affect exchange rates as noted below.

Under the gold standard wherein exchange rates were not free to move except within the narrow limits of the gold points, the adjustments between exchange rates and prices took place in the price levels. A country losing gold because its prices were too high on the basis of the exchange rate, and its exports therefore inadequate to provide it a supply of foreign currency, tended to have lower prices, monetary incomes, and employment, whereas a country receiving gold, with relatively low prices and large exports, tended to have higher prices, incomes, and employment as the additional gold expanded the money supply. These price level and income movements continued until price relationships were in approximate balance in terms of the exchange rate. When a fixed rate is maintained and when these automatic adjustments of prices do not operate, either because, as during the nineteen twenties, gold movements are not allowed to affect prices and to cause disturbing inflation or deflation, or because, as in recent years, deficits in balances of

payments are ordinarily not met by gold payments, overvaluation or undervaluation may exist.

Limitations of Purchasing Power Parities.—Movements in price level relationships, that is in purchasing power parities, do not provide a complete explanation of movements in exchange rates. The purchasing power of a currency, especially as reflected in a country's wage rates and other costs of production, is an important factor in the demand and supply of bills, but there are also other factors which may cause a change in demand and supply, and consequently in rates, without any change in price levels having taken place. For example, real changes in production such as improved techniques may cause a country to export substantially more of a particular article with the result that its currency is in strong demand abroad, or a change in consumers' tastes and in the demand for certain products may cause a shift in demand and supply and in exchange rates. Real changes in foreign trade and in the demand and supply of bills may be accompanied by little or no change in prices. An increased demand for an article and consequent enlarged production of it may result in lower costs and prices for the article, or perhaps higher prices or no change at all. Yet the increased demand for the producing country's currency may require a higher exchange rate to bring equilibrium in international accounts.

The flow of capital may also alter exchange rates independently of price movements. The flow of capital is sometimes of a continuing and fairly stable nature, especially when it represents new investment, and again it may be erratic and unpredictable, as when capital flees a currency or country because of fear. Capital transfers, to the extent permitted by governments, are constantly taking place between countries and are an important element, sometimes a dominant element, in the demand and supply of bills in the exchange market.

The real changes or shifts in international demand which affect a country's exports and imports or other foreign transactions ordinarily require considerable time before they assume sizable proportions. Changes in price levels may take place more rapidly and are likely to result in overvaluation or under-

valuation under a system of fixed rates. This was the situation which prevailed after the second World War. Changes in the flow of capital can, of course, take place quickly and exert a strong influence on exchange rates in a short period of time, causing a considerable departure from the purchasing power parity if rates are free to move.

A further reason why purchasing power relationships do not in themselves fully explain exchange rates is that price indices do not always reflect adequately cost changes in the commodities most significant in a country's foreign trade. A price rise may be concentrated in certain domestic commodities which have little relation to the country's foreign transactions. Price controls, moreover, tend to conceal currency depreciation and thereby cause purchasing power parity calculations to be unrepresentative. Latent inflation is not revealed in such calculations.

Purchasing power parity computations are useful as a guide in determining whether a currency appears undervalued or over valued at an existing exchange rate, and in determining what rate may be an equilibrium rate. They are useful as a point of departure from which adjustments can be made for real changes and other factors that affect the balance of payments. They are especially helpful in periods of rather drastic price movements such as followed the second World War, although the extensive use of price controls made difficult the computation of meaningful figures.

After the first World War, on the basis of 1913 prices, purchasing power parities were significant indicators of where exchange rates settled under the conditions of free exchange which prevailed after that war. When the pound, the franc, and the lira were unpegged in 1919, exchange rates promptly declined to levels not far from the purchasing power parities based upon 1913 price relationships. Currency stabilization after the first World War was accomplished with little careful study or coordination between countries. Had more attention been paid to relative changes in prices and costs, some of the subsequent balance of payments and exchange difficulties could doubtless have been avoided.

Chapter 7

BALANCE OF PAYMENTS

Nature of Balance of Payments.—The foreign trade of a country has two sides, and consists of the goods and services which it gives and the goods and services which it receives in exchange. The two-sided nature of foreign trade was clear in the case of the early traders who sailed vessels laden with domestic products to foreign lands where these products were sold or exchanged for various foreign goods. The vessels thereupon returned laden with these foreign goods, or perhaps with precious metals. The goods that were exported constituted payment for the goods that were imported and the two-sided or balanced nature of the trade was apparent. The dual nature of trade, however, is obscured today by our complicated exchange mechanism involving money, credit, and numerous intermediaries to a transaction. An exporter may never see his foreign importer face to face, nor is he concerned with the other half of the transaction, namely the goods which are imported with the monetary proceeds of his exports, proceeds which he has disposed of for dollars. In spite of our intricate exchange machinery, trade is essentially giving and receiving. The exports of a country are given in exchange and pay for the imports, and vice versa.

The dual nature of trade has sometimes been misunderstood and it has been assumed that nations can in some manner have large exports without importing from abroad, or vice versa, or that exports are an end in themselves. In a trade between two individuals, as when one boy swaps his knife for another boy's baseball, the boy who receives the knife pays for it with his baseball, and the boy who receives the baseball pays for it by parting with his knife. Furthermore, the knife is worth more

to the boy who receives it than the baseball he gives up, otherwise he would not be willing to make the trade. Similarly, the baseball is worth more to the boy who receives it than the knife which he gives up. Both parties to the transaction benefit, or think they do at the time of the trade.

Regardless of the financial arrangements, trade between nations is similarly on a *quid pro quo* basis, except in the case of gifts. Goods which a nation exports are payment for those which it imports, or for services which it receives, or are to meet other obligations owing to foreigners, and vice versa. If we wish to sell abroad, we must also buy from abroad; otherwise the foreigners will not possess our money with which to purchase our goods.

Exports and imports include more than the physical commodities which move in and out of a country. Many intangible or invisible items require payments and must be included in a study of a country's total payments and receipts. Services rendered to foreigners are similar in nature to exports to foreigners, since the services must be paid for by the foreigners just as though our merchandise were sold to them. When Americans ride in British ships they have received a service which must be paid for just as though they had imported commodities from Great Britain. Similarly, if an American visits Paris his food and entertainment must be paid for by exports from the United States. It makes no difference whether a Dutch cheese is consumed by an American in Amsterdam or is sent to an American in New York. In either event it must be paid for by the export of American goods or the rendering of services by Americans. Services rendered to us by foreigners, often called invisible imports, must be paid for by us in the same manner as visible imports into this country.

Whenever the United States imports goods or receives services from abroad we owe someone abroad and are the debtor. On the other hand whenever we export goods or render services, foreigners owe us and we are the creditor. In a balance of payments analysis we are concerned not merely with merchandise movements but with the total payments that we must make to

foreigners for whatever reasons and with the total amount that they must pay us for whatever reasons.

A study of foreign trade from the standpoint of a country's payments and receipts and their relationship to each other deals with values rather than with the quantities of goods imported and exported. Quantities have their significance, as discussed later, but foreign trade ordinarily takes place in terms of specified values, except in the case of barter trade which is rare. It is so many dollars, pounds, francs, or pesos that are owed rather than tons, bushels, or bales. The values at which goods are traded change constantly, but each transaction means that a certain amount of money of some country is to be paid to a foreigner. The balance of payments of a country therefore concerns itself with monetary values rather than with the quantities of goods.

The term "balance of payments" refers to a statement setting forth all the economic transactions during a given period between residents of one country and residents of all other countries. Some of these transactions involve payments and some of them involve receipts. A balance of payments statement is thus a complete record of a country's total foreign transactions during the given period, and it shows how much was bought, sold, borrowed, loaned, due for services, etc. Transactions which create indebtedness to residents of foreign countries, and which therefore involve payments by us abroad, are called debit or payment transactions. They are those transactions, such as imports, which create claims against us. The credit or receipt transactions, such as export transactions, are, on the other hand, those which involve payments to us by foreigners.

If all transactions are included, the payments and receipts must be equal inasmuch as each transaction has its counterpart. The system is one of double-entry bookkeeping wherein total debits necessarily equal total credits. The transactions may be set forth in the form of a balance sheet with credits on one side and debits on the other side. Thus an export transaction, a credit or receipt, would be offset by an import transaction in the event that the proceeds of the exports were used to buy foreign

goods. If the proceeds were left abroad as a deposit in a foreign bank the offsetting debit would then be an increase of bank balances held abroad. In any event the proceeds, depending on their disposition, would appear somewhere among the debits.

A balance of payments statement, of course, does not identify individual transactions on one side of the balance sheet with those on the other side, but rather presents total exports, imports, services given and received, etc. Inasmuch as records are sometimes incomplete or involve estimates a precise equivalence is not to be expected. A balancing item of errors and omissions may therefore be necessary. In commercial accounting the two sides of every transaction are posted simultaneously so that a perfect balance is constantly maintained. This is obviously not possible in drawing up a balance of payments statement for the diverse transactions of a country.

While a balance of payments statement must necessarily balance, it is frequently said that a country has a deficit in its balance of payments. In such cases reference is made to the fact that its total export transactions are inadequate to pay for its total import transactions apart from those transactions which are for the specific purpose of bringing accounts into balance. The difference must be made up by exporting gold, drawing down bank balances held abroad, foreign borrowing, selling foreign investments, or in some other manner. A country with a surplus in its balance of payments would, on the other hand, be receiving gold, adding to its foreign assets, reducing its liabilities to foreigners or making donations. Deficits and surpluses are discussed on pages 126-27.

Sometimes the discussion is in terms of merchandise imports and exports only and the expression trade balance is used, referring to the surplus or deficit in such merchandise exports or imports. The trade balance by itself, however, usually has little significance since an excess of merchandise imports, which would create a trade deficit, may be more than offset by the rendering of services to foreigners so that no deficit in total current transactions exists.

The statement that a balance of payments must necessarily balance does not mean that the foreign trade of a particular

nation must balance with each other nation individually. It does mean, however, that the foreign trade of a nation must balance with all nations combined. For example, the United States has long bought a large amount of coffee and other articles from Brazil. Brazil, however, on the basis of the prewar flow of trade, purchased extensively in Great Britain and other countries, so that the United States bought from Brazil more than it sold there. At the same time, the exports of the United States to Great Britain and to other countries helped to pay for the purchases of the United States in Brazil. The trade may be looked upon as triangular. Brazil exported to the United States, the United States to Great Britain, and Great Britain to Brazil. All three countries therefore were paid. In actuality the trade was not quite so simple. Our triangle became a many-sided polygon, and only when the trade of Brazil with all other nations was included would a balance be struck and Brazilian exports equal Brazilian imports. The United States normally exported to Europe, Europe to South America and the Far East, and these latter areas sent raw materials to the United States which helped to pay for the goods the United States sent to Europe. While the second World War disrupted this general pattern it has tended to reassert itself again.

Mercantilist Views on Foreign Trade.—According to the doctrines of the mercantilists of some 300 years ago, a state should endeavor to have a net balance of exports so that gold and silver would be received in payment.[1] A strong state was supposed to be one that had a large amount of gold and silver. This teaching was traceable in large part to conditions of that time, particularly to the fact that states were continually engaged in armed conflict, and that the state with plenty of treasure was better able to carry on military activities. Gold and silver were regarded as the most important forms of wealth. Accordingly, a nation's industrial and commercial policies should be aimed toward the accumulation of as much of the precious metals as possible. Since a large export trade tended to bring these metals into the country in payment for the goods

[1] For a more complete discussion of mercantilism see Chapter 13.

sent out, the development of foreign markets was regarded as important. A healthy condition of foreign trade was considered to be one in which merchandise exports were in excess of merchandise imports, so that the difference would have to be made up by the importation of the precious metals.

In order to encourage exports, and to discourage imports, mercantilism taught that tariff duties and other restrictions should be imposed upon the importation of foreign goods. The purchase of goods from foreigners tended to take treasure out of the country in payment, while the sale of goods to foreigners tended to bring treasure into the country. Export industries, especially manufacturing, were thus to be given bounties and other forms of encouragement. Shipping was to be aided as much as possible, since plentiful shipping facilities stimulated foreign trade.

An excess of merchandise exports was known as a favorable balance of trade, while an excess of imports was known as an unfavorable balance. This terminology has continued to the present day. It should be clear, however, that the words favorable and unfavorable are misleading as to desirability. An excess of imports or exports does not necessarily indicate conditions which are either desirable or undesirable. Before the second World War Great Britain had long had an unfavorable balance of trade, one of the reasons being that Great Britain had large investments abroad. The rest of the world owed money to Great Britain and was paying interest and dividends—not a particularly unhealthy condition from the standpoint of Great Britain. On the other hand, a nation heavily in debt to foreigners and with burdensome interest payments to make may have a so-called favorable balance of trade, the excess of exports representing interest payments.

While these ideas of the mercantilists may seem unrealistic at the present time, if we could transplant ourselves to their day the doctrines would appear more practical. A large amount of the imports in those days consisted of spices, silks, and other luxuries. When plenty of cash was a matter of vital importance to a sovereign in a period of incessant conflict, the importation of gold and silver seemed more worth while than that of nutmeg

or cinnamon. War was a normal state of affairs and ample cash resources were therefore important for survival.

While the importation of gold and silver tended to cause an inflationary rise of prices it also tended to stimulate economic activity. As discussed in the chapter on National Income and the Foreign Trade Multiplier the importation of monetary metals tends to expand output and employment. Although the economies of that period were quite simple according to present day standards, and a large portion of production was consumed without entering the channels of trade, nevertheless the importation of money and its entry into circulation tended, according to available records, to stimulate production and incomes.

At the present time while a so-called favorable balance of trade may be helpful in adding to the country's foreign-exchange resources, foreign exchange that is earned by services rendered and other invisible exports is just as helpful as that earned by merchandise exports.

Items in Balance of Payments.—The balance of payments of a country is customarily presented in the form of a statement which sets forth all the foreign transactions of the country during a given period, insofar as statistical compilations permit completeness, showing the debit or payments transactions in one group and the credit or receipt transactions in another group. Gold and capital movements are usually shown separately. The statement shows how much the country in its international transactions bought, sold, borrowed, loaned, owed for services received, was owed for services rendered, and paid or received in interest, dividends, etc. The transactions which create indebtedness of persons in our country to persons in foreign countries, or which involve payments by us abroad, are the so-called debit or payment transactions. The credit or receipt transactions, on the other hand, are those which involve payments to us by foreigners or which create indebtedness to us from foreigners. In addition to transactions which involve a payment or a receipt, are unilateral transfers, namely grants, etc., wherein no financial obligation is created. The following are the principal items in the balance of payments:

Debit or Payment Items

Current Transactions. IMPORTS OF MERCHANDISE. The nature of this item is clear. All goods that we receive from abroad, whether cloth from England or pig bristles from Wuchang, must be paid for by us. They are to be listed on the debit side of the balance sheet since they create claims against us and are offset by credits of some kind which we have created or will create by such means as the export of merchandise. Merchandise trade represents by far the largest single item in the current transactions.

SERVICES RECEIVED BY AMERICAN TRAVELERS ABROAD. If an American travels abroad he receives various services and consumes foreign commodities for which he must pay. These services rendered to him increase the aggregate indebtedness of Americans to foreigners and constitute a debit item on the balance sheet.

TRANSPORTATION SERVICES RECEIVED. The ships of Great Britain, the Scandinavian countries, France, Italy, and other countries carry a large portion of our foreign commerce. Before 1914 they carried practically all of it. Foreign ships and airplanes carry many American passengers as well as much American cargo. Similarly, foreign railroads render services to Americans. Transportation services for which foreigners must be paid are an important debit item.

INSURANCE AND BANKING SERVICES RECEIVED. Many foreign insurance companies insure or reinsure risks for Americans. Particularly is this the case in the field of marine insurance, where a large proportion of the premiums which Americans pay go to British insurance companies. Banks and other foreign financial institutions also perform services for Americans. The charge for these services is a debit or payment item from the American standpoint. From the foreign standpoint these services are credits, as are shipping and other services to Americans.

INTEREST AND DIVIDENDS PAID FOREIGNERS. A large amount of foreign capital has been invested in the United

States. As interest and dividends upon this capital are earned, the United States becomes indebted to the foreign owners of the capital for these amounts. Interest and dividends paid abroad are therefore debits. Such investment income due foreigners represents payments which we are obliged to make, and which are to be provided for by merchandise exports, services rendered by us, and other credits.

GOVERNMENT EXPENDITURES ABROAD. Government expenditures in foreign countries have increased greatly in recent years. Diplomatic and military expenditures account for a large portion of this amount. These expenditures of our government provide foreigners with dollars in the same manner as in the case of our imports of their merchandise, services received from them or the remittance to them of investment income. Such payments are a debit item.

DONATIONS TO FOREIGNERS. A large amount of money is given to foreigners in the form of donations or grants. The United States government has extended grants of several billion dollars to foreign governments. In these unilateral transfers nothing is received in return. Many persons in America remit sums of money to relatives and friends in foreign countries or make charitable contributions of one kind or another to foreigners. Red Cross, church and other institutional remittances constitute an important part of foreign donations. These donations are to be listed as a debit, although the people in America who remit have not received goods or any specific service for which they are paying. They are not in debt to foreigners in the ordinary sense, but the remittances are sent anyway, and are to be offset by the shipment abroad of American goods or the rendering of services by the United States.

MISCELLANEOUS TRANSACTIONS. The above transactions account for the chief sums paid currently to foreigners during the course of a year, or whatever period is covered by the balance of payments statement. There are, however, numerous smaller transactions which involve additional debtor-creditor relationships between residents of one country and those of another country. Advertising fees which American companies

owe foreigners amount to a sizable sum. The importation of electric power into the United States from Canada, telegram and cable services received by us from foreign companies, legal services and patent and copyright purchases, and royalties due foreigners, also mean that we owe money abroad. These are debit items.

Capital Movements and Monetary Gold. LONG-TERM CAPITAL SENT ABROAD. Whenever we import foreign stocks, bonds, or other financial obligations we must pay for them. Their importation like that of merchandise requires a payment by us. Once these securities are paid for, however, we are the creditor, since the securities themselves are evidences of debt or represent investments by us abroad. The importation of these securities represents American capital going into foreign countries, either as a loan or as an investment. Capital exported (securities imported) is to be entered at the time of exit as a debit transaction. Such payments made to foreigners are not for merchandise imports received by us, nor are they payments for services rendered to us. The payments are for foreign securities which we have received and which are evidences of indebtedness or investment. Loans by our government to foreign governments are to be included under this heading. In order to get the capital abroad we must send goods, render services, or make payment in some way.

REPAYMENT BY AMERICANS OF LOANS AND INVESTMENTS. Payments made by us to extinguish foreign loans previously made to us are also debit items, and are of a similar nature, from the standpoint of the balance sheet, to new capital sent abroad. In both cases payments are made to foreigners, but in one case the purpose is to repay obligations whereas in the other case the purpose is to make new investments. The repayment or amortization of foreign loans, or the withdrawal of foreign investments here, may be thought of as the importation into America of our own obligations or securities previously exported. To import these means that we must buy (repay) these obligations or securities and pay for them just as though we were paying for merchandise imported. Our own securities

imported are similar in nature to foreign securities imported or to merchandise imported.

SHORT-TERM CAPITAL SENT ABROAD. In addition to long-term loans and investments are exports of capital of a short-term nature. These exports include an increase in our deposit balances in foreign banks, an increase in our holdings of commercial obligations or short-term government obligations. An increase in open book accounts owing our exporters would also be included here. These transactions are debits for the same reason as long-term capital exports are debits.

GOLD IMPORTS. The importation of gold requires payments to the foreigners that shipped the gold just as though they had sent commodities. Gold imports are therefore a debit item.

Credit or Receipt Items

The credit or receipt transactions are the opposite of the above debit or payment transactions. In view of the above discussion a detailed explanation of credit items is not necessary. Credit transactions pay for the debit transactions and consist principally of the following:

Current Transactions. EXPORTS OF MERCHANDISE. Goods sent abroad mean that foreigners owe us; the goods create a credit in our favor.

SERVICES RENDERED BY US TO FOREIGN TRAVELERS. For these services foreigners must pay us.

TRANSPORTATION SERVICES RENDERED BY US.

INSURANCE AND BANKING SERVICES RENDERED BY US.

INTEREST AND DIVIDENDS PAID TO US BY FOREIGNERS. These are paid to us as earnings on investments which we have abroad.

FOREIGN GOVERNMENT EXPENDITURES HERE. Foreign governments require dollars for these expenditures as though the governments were paying for our exports.

DONATIONS TO US BY FOREIGNERS.

MISCELLANEOUS TRANSACTIONS. Motion picture rentals paid to American companies constitute an important item in the miscellaneous group and are to be listed on the credit side of the balance sheet. Subscriptions to publications, patent royalties, and other transactions are also included here.

Capital Movements and Monetary Gold. LONG-TERM FOREIGN CAPITAL SENT HERE. Such transactions mean that our securities have been exported and that we must therefore be paid.

REPAYMENT TO AMERICA OF MONEY LOANED OR INVESTED ABROAD. The process involves current payments to us.

SHORT-TERM CAPITAL RECEIVED.

GOLD EXPORTS.

Certain types of transactions are frequently more important on one side of the balance sheet than on the other, and also vary greatly from country to country. For example, travel expenditures and donations are more important on the debit side of the American balance sheet than in that of most other countries. Americans travel more widely than do most foreigners. They are also in a position to be more generous in their contributions abroad so that donations are large on the debit side. Motion picture royalties received are also more important in the American balance sheet than in those of other countries. In the British balance sheet, shipping services rendered constitute an important item.

Deficits and Surpluses.—It was noted above that a country's balance of payments necessarily balances because each transaction has a counterpart which is entered on the opposite side of the balance sheet. Unilateral transfers such as gifts are entered on the statement in order to offset an export or import for which the unilateral transfer provides. If all transactions are recorded there is, therefore, no deficit or surplus in the sense of unaccounted transactions. On the other hand according to common usage a deficit or surplus in the balance of payments frequently exists; in fact a principal purpose of a balance of

payments statement is to set forth the nature and amount of this deficit or surplus.

Reference to a deficit or surplus in such discussions is to whether the country is paying for its total imports and other payment transactions by exporting gold, drawing down its foreign assets, acquiring foreign liabilities or receiving donations for the specific purpose of establishing a balance (a condition of deficit), or whether its total exports and similar receipt transactions are more than enough to pay for the imports and result in an excess requiring financing (a condition of surplus). In the latter case the country is either importing gold, adding to its foreign assets, reducing its foreign liabilities or making donations. The terms deficit and surplus are thus used to describe the relationship between total export and import transactions except those which are undertaken for the specific purpose of bringing accounts into balance.

The deficit or surplus in international transactions does not by itself necessarily indicate the changes in a country's capital position. For example, when exports to foreign countries represent donations such as government grants (as in the case of UNRRA and Marshall Plan aid), or perhaps reparation payments, no payment in return is received and the capital account of the exporting country is not increased by these surplus exports. Similarly the countries receiving the gifts, grants or reparation payments, even though they show a deficit because of these receipts, would not thereby have reduced their foreign capital account.

Balance of payments statements are especially useful to governments in dealing with their foreign exchange problems. From the standpoint of government policy with respect to possible changes in the exchange rate, the imposition or relaxation of exchange restrictions, and the taking of fiscal and monetary measures, the country's deficit or surplus is of primary significance. By itself, however, the mere existence of a deficit or surplus is not a complete guide to government policy. The trend, extent, and probable duration of the deficit or surplus are to be weighed, which involves consideration of such things as the particular items which contribute to the deficit or surplus.

If a country has an excess of imports that is being financed by the inflow of new investment capital, the country's receipts of foreign exchange may be adequate to meet all current demands at the prevailing rate of exchange and no serious exchange problem may exist. No over-all deficit therefore exists so long as the capital inflow continues in sufficient amount. On the other hand, an excess of imports that is financed by grants from abroad, foreign borrowing, the export of gold or the drawing down of foreign balances specifically to provide for the deficit, confronts the government with important decisions regarding a possible alteration in the rate of exchange, a reduction in government expenditures, limitation of imports, or other actions to remedy the situation.

At the present time the state of a country's balance of payments is to a considerable extent the result of governmental policies and actions. Deficits or surpluses are not impersonal things that exist apart from government programs and their implementation. Moreover, the means by which a deficit is financed is also to a large extent a matter for government decision. The deficit calculated for such administrative purposes should be one which excludes those transactions which result from the government measures taken specifically to provide exchange to meet the deficit.

Compensatory Official Financing.—The International Monetary Fund staff has been studying this problem and has suggested the concept of what it calls compensatory official financing, referring to "financing undertaken by the monetary authorities to provide exchange to cover a surplus or deficit in the rest of the balance of payments." [2] The Fund has sought a working concept of surplus and deficit useful to governments in connection with their exchange problems, and has therefore arranged the items so as to reveal the deficit after eliminating transactions that are taken specifically to provide for such deficit. Compensatory financing is by nature almost inevitably of an official character and undertaken by government authorities.

[2] *Balance of Payments Yearbook* (Washington, D.C.: International Monetary Fund, 1949).

A difficulty with such a concept from the standpoint of statistical compilation is that in the case of practically all countries most of the items that make up the country's foreign trade are to a greater or less degree not independent of governmental actions which may be directed at least in part to the promotion of balance of payments equilibrium. For example, a foreign loan may be contracted by the government or with the help of the government for development purposes but with the knowledge that it will at the same time aid the exchange situation. In spite of such overlapping, it is usually possible to isolate the principal balancing transactions. It is helpful from the working standpoint to know the amount of deficit exclusive of items that are directly and immediately the result of balancing actions taken by the government.

Movements in international reserves, in the form of gold and foreign exchange balances, are basic in this concept of compensatory official financing. Utilization of such reserves, drawings on the International Monetary Fund, or other official financing to cover a deficit are undertaken solely because of the deficit. Gold movements which cover a deficit need to be adjusted, however, to allow for the export of newly produced gold, which is in the same category as the export of a commodity. A country exporting newly produced gold and paying for imports with it should not be considered to have a deficit because it pays for imports with such gold.

Movements in a country's international reserve position are indicated not only by changes in these assets themselves but also by changes in the country's foreign liabilities. An increase in short-term liabilities, which weakens the reserve position, is a means of providing exchange for a deficit and may be part of compensatory financing.

Compensatory financing of a deficit is usually undertaken to facilitate orderly exchange conditions, particularly the maintenance of the exchange rate. In the economies of today wherein government regulation includes supervision over foreign trade and the maintenance of an exchange rate which may be far from an equilibrium rate, a deficit in the balance of payments is not entirely unplanned. Regardless of the wisdom of policies which

contribute to such a deficit, the deficit must nevertheless be financed in order to prevent exchange depreciation, the imposition or increase of exchange restrictions, or other measures.

Balance of Payments of United States.—The following is a balance of payments statement for the United States based on data compiled by the Department of Commerce setting forth as accurately as statistics permit all of this country's foreign transactions during the year.

TABLE 6[1]

INTERNATIONAL TRANSACTIONS OF THE UNITED STATES, 1950
(Millions of dollars)

I. Goods and Services			
Receipts (Credits)			
Exports of Goods and Services:			
Merchandise, adjusted	10,679		
Transportation	1,008		
Travel	374		
Miscellaneous services			
Private	567		
Government	153		
Income on Investments:			
Private	1,461		
Government	109		
Total		14,351	
Payments (Debits)			
Imports of Goods and Services:			
Merchandise, adjusted	9,287		
Transportation	846		
Travel	727		
Miscellaneous services			
Private	258		
Government	602		
Income on investments:			
Private	389		
Government	33		
Total		12,142	
Balance on Goods and Services			+2,209
II. Capital and Unilateral Transfers			
Net Debits (—), or credits (+)			
Unilateral Transfers:			
Private	— 439		
Government	—4,043		
Other	— 90		
Total			—4,572

[1] The absence of an item Errors and Omissions in the calculations for 1950 is due to a coincidence. Ordinarily the debits and credits do not precisely balance.

UNITED STATES CAPITAL:		
Private long-term	— 950	
Private short-term	— 140	
Government long-term	— 125	
Government short-term	— 34	
Total		—1,249
FOREIGN CAPITAL:		
Long-term	+1,001	
Short-term	+ 868	
Total		+1,869
U. S. GOLD		+1,743

(Source: Department of Commerce.)

A balance of payments statement for the United States, prepared by the International Monetary Fund and presented in a manner to show the extent of the compensatory financing is shown in Table 7. The figures are based on those of the Department of Commerce but are not always identical due largely to differences in classification.

TABLE 7

INTERNATIONAL TRANSACTIONS OF THE UNITED STATES AND THEIR FINANCING [1]

(In millions of U.S. dollars)

	1938	1946	1947	1948	1949	1950 [2]
A. GOODS AND SERVICES:						
Exports, f.a.s.	3,101	10,245	15,127	13,077	12,298	10,679
Imports, f.a.s.	—2,177	—5,025	—6,072	—7,787	—7,105	—9,287
Trade balance	924	5,220	9,055	5,290	5,193	1,392
Nonmonetary gold	142	—85	19	7	—26	.
Foreign travel	—173	—205	—206	—292	—325	—353
Transportation	—36	821	1,027	657	521	162
Investment income	431	860	1,191	1,515	1,346	1,148
Government, not included elsewhere	—46	1,217	470	—269	—374	—536
Other services	77	181	190	192	166	309
Total	1,319	8,009	11,746	7,100	6,501	2,122
B. PRIVATE DONATIONS AND CAPITAL MOVEMENTS:						
Donations	—153	—672	—662	—649	—513	—439
U. S. private capital						
Direct investment	—38	—485	—1,123	—1,265	—1,329	—718
Bank assets	31	128	—37	28	80	—405
Other	20	92	—65	—137	40	
Foreign private capital	70	—309	—60	—36	145	1,068 [4]
Total	—70	—1,246	—1,947	—2,059	—1,577	—494

	1938	1946	1947	1948	1949	1950 [2]
C. SPECIAL OFFICIAL FINANCING:						
Lend-Lease settlements, etc.	3	203	254	161	19	21
Repayment of U. S. Government loans	...	77	278	296	198	288
Short-term credits [3]	...	104	16	93	—171	—72
U. S. Government donations extended	—21	—202	—310	—247	—314	—781
U. S. Government loans extended	...	—74	—76	—64	—102	—216
U. S. Government direct investment abroad (net)	...	2	1	—1	—1	...
IRO, ICEF, and UN (Palestine refugee) donations	...	...	—33	—116	—103	—51
IBRD loans	..		—5	—15	—54	—67
Total	—18	110	125	107	—528	—878
D. NET ERRORS AND OMISSIONS	249	179	980	1,046	936	...
E. SURPLUS (A THROUGH D)	1,480	7,052	10,904	6,194	5,332	750
F. COMPENSATORY OFFICIAL FINANCING:						
U. S. Government:						
Grants extended	...	—732	—1,312	—3,919	—5,046	—3,379
ECA counterpart funds	...	...	49	22	230	144
Credits: Long-term	...	—3,037	—4,020	—1,205	—586	—163
Short-term	...	—168	—24	—141	116	38
International institutions:						
UNRRA	...	—1,529	—543	...	...	...
IBRD loans	...	...	—295	—178	—7	...
IMF dollar sales	...	...	—462	—203	—99	21
Foreign governments and banks:						
Use of dollar assets	319	—979	—1,450	960	224	846 [4]
Net sales (—) of gold to U. S.	—1,799	—607	—2,847	—1,530	—164	1,743
Total	—1,480	—7,052	—10,904	—6,194	—5,332	—750

[1] No sign indicates credit; minus sign indicates debit.

[2] These data are preliminary and are based on Department of Commerce classifications; hence they are not strictly comparable with the data for earlier years.

[3] Includes increases (credits extended) and decreases (repayments) of U. S. "other" official institutions' foreign exchange holdings as well as short-term credits.

[4] Foreign private capital includes, and foreign governments' and banks' use of dollar assets excludes, an undetermined amount of foreign governments' purchases of U. S. Government long-term securities.

(Source: International Monetary Fund)

Chapter 8

BALANCE OF PAYMENTS ADJUSTMENTS

In the chapter on "Balance of Payments" it was noted that a country's exports provide it with the foreign currency needed to pay for its imports. If its current exports are inadequate for this purpose so that the country finds it necessary to draw on its gold or foreign exchange reserves, to increase its foreign liabilities, or reduce its foreign assets, its current foreign payments and receipts are not in equilibrium and a deficit exists in the sense noted in the previous chapter.

Under completely free market conditions (which, however, seldom exist today), wherein trade, prices, and exchange rates are allowed to move without hindrance, automatic forces operate to remove a surplus or deficit and to bring the trade between the country and the rest of the world into balance. Crop failures, changes in demand, and various other disturbing events are constantly arising and tend to cause a lack of balance between current payments and receipts, but the automatic forces which are thereby set in motion tend promptly to restore a balance, if they are permitted to operate freely. Individual exporters and importers are ordinarily not concerned with the effects of their separate transactions upon the country's total balance of payments. Yet under a free market economy these transactions in the aggregate achieve a balanced position.

One of the tasks of international trade theory is to explain how the balancing adjustments in international accounts come about and how they are affected by government regulatory measures. In a free market economy balance of payments adjustments are brought about automatically through movements in (*a*) exchange rates, (*b*) prices, and (*c*) incomes. Where these equilibrating forces are not allowed to exert their influence

sufficiently to bring a balance governments frequently endeavor to balance accounts, in the case of a deficit, by the limitation of imports, and especially by the placing of restrictions on the purchase and sale of foreign currencies. A surplus is less disturbing to the economy in the immediate sense, since it does not create a scarcity of foreign exchange, but if long continued raises problems of another order.

Adjustments Through Movements in Exchange Rates.— When exchange rates are allowed to move freely any immediate lack of balance between a country's exports and imports, or more precisely between its total current payments and receipts, is quickly remedied through movements in the exchange rate, in the same manner that the price of a commodity in a free market brings equality between the demand and supply of the commodity at the prevailing price. A freely moving exchange rate clears the market of foreign bills and keeps demand and supply in equilibrium. The adjustments that are brought about by a movement in the exchange rate may be drastic, accompanied by economic disturbances and readjustments in domestic production and employment. The movement in rates, however, equilibrates the demand and supply of foreign currencies, and thereby forces a balance in accounts.

In bringing about an immediate equivalence between current export and import items a movement in the exchange rate alters the values of the exports and imports (calculated in terms of the exchange rate) and therefore alters the ratios at which goods and services are traded. For example, if one pound of coffee costs one peso and a yard of cloth one dollar, and if the exchange rate is twenty-five cents per peso, four pounds of coffee are being traded for one yard of cloth and the trade is in balance at a value of one dollar, or four pesos if stated in terms of pesos, assuming there is no other trade. If, however, cloth becomes more greatly desired, and dollars are therefore in strong demand to pay for the cloth so that the exchange rate which brings equilibrium is 12.5 cents, eight pounds of coffee are being traded for one yard of cloth and the value of the trade, assuming twice as much cloth is sold, is now two dollars or

sixteen pesos. A change in the rate of exchange which may be required to bring equilibrium thus alters the terms of trade and thereby brings a value equivalence between exports and imports as calculated in terms of the exchange rate. It will be noted that it also alters the amount of trade.

A rise in the exchange rate on foreign countries (foreign currencies more expensive) increases the local cost of imported goods since the foreign currencies which are needed to pay for these goods cost more local money. Such a rise in the cost of imported goods encourages the consumption of domestic commodities in preference to foreign goods formerly imported. Imports thus tend to decline, as does the demand for foreign currencies in the exchange market. This reduction in demand tends to counteract the initial rise in the rate.

On the export side exporters find that the foreign currencies received from their sales will, at the higher exchange rate, convert into a larger amount of local money. Their products will probably continue to sell at approximately the same prices in foreign countries as before, or perhaps slightly less, since demand and supply conditions there have presumably not changed greatly in view of the existence of many other suppliers. The exporters therefore push their sales abroad, and exports tend to increase. As exports increase a larger supply of foreign currency becomes available and tends to counteract the initial rise in the rate, as in the case of the reduced import demand.

In altering the costs of imported goods to domestic consumers, and the profits to exporters, a movement in exchange rates, it will be noted, alters the amounts of goods imported and exported. These changes in imports and exports tend to reduce the magnitude of the initial adjustment in the rate. The decline in imports and the increase in exports are reflected in the demand and supply of foreign currencies in the exchange market and therefore in the equilibrium rate of exchange.

The extent to which imports and exports increase or decrease as a result of a given change in the exchange rate depends primarily upon the price elasticities of demand for and supply of the commodities and services which enter into foreign trade, both at home and abroad (as discussed in Chapter 6), and also

upon the price elasticities of demand for and supply of certain competing domestic goods and services. If the demand for foreign goods and services is elastic a slight change in the rate may be sufficient to cut off substantial imports and bring equilibrium. On the other hand an inelastic demand for foreign goods, as is often the case, may require a considerable increase in the exchange rate to reduce imports and bring an equilibrium. The situation would be aggravated if the foreign supply were also inelastic and foreigners offered our importers almost as much as before but at lower prices so that large imports continued. However, unless the importing country were a very large consumer of the inelastic imported goods, it is probable that such a country's reduction in purchases would not affect the world price materially and that it would therefore not be able to purchase at lower or much lower prices. The inelasticity of foreign supply would therefore not be much of a deterrent to equilibrium.

An expansion of a country's exports, following an increase in the exchange rate, does not necessarily require that foreign countries consume larger quantities of the particular goods exported. Perhaps the foreign demand for such goods is inelastic so that even though an exporting country can sell at lower prices because of the new rate of exchange, foreign countries still may not wish to consume much more. The fact of inelasticity, however, may not interfere with an expansion of exports and with the balancing adjustments. The exporting country can now undersell foreign competitors if necessary and obtain, at the expense of some other country, a larger share of the world market than formerly. This may not require much of a reduction in price.

It is possible that if a country lowers its exchange rate, and the foreign demand for its products is inelastic, while its exports will sell for less they will not expand sufficiently in volume to offset the loss from the lower selling prices. If the foreign demand is inelastic, i.e., less than unity, a lower exchange rate may mean that the country sells the same amount, or perhaps slightly more, at lower prices and obtains a reduced total sum of foreign currency. The foreign currency, however, would con-

vert into more domestic money. Although imports into most countries do not exhibit much price elasticity, it is doubtful whether this situation, a reduction in net foreign exchange earnings accompanying a lower rate, often exists. The reason is that most international prices are not greatly affected by a lower exchange rate for the currency of only one of the suppliers of the commodities traded in the international market, unless the supplier's product represents a major portion of the total traded.

A change in the rate of exchange may cause certain substitutions in the consumption of foreign as opposed to domestic goods (or vice versa), and thereby facilitate the establishment of equilibrium. If foreign goods cost more at the new rate of exchange, home producers may be able to produce for the local market goods which formerly could not be produced at home and sold at a price in competition with foreign goods. Money spent for foreign goods becomes available for the purchase of home produced goods, which may be like or unlike those imported. Similarly, exporters may find that certain goods formerly not exported can now be produced at home and sold abroad in competition with foreign goods, whereas formerly local costs and the previous rate of exchange would not permit this.

A change in the rate of exchange and resulting shifts in exports, imports and domestic production causes a reallocation of local productive resources. Some of these adjustments in production may take a considerable period of time as in the case of articles the production of which requires elaborate equipment which cannot be expanded quickly. The immediate effects of a change in rate may therefore not be the ultimate effects. A drastic depreciation of the rate may in some instances be necessary to bring immediate equilibrium, particularly in cases where the supply of exports in the short term is relatively fixed, whereas when the necessary internal adjustments shall have taken place a more moderate reduction would suffice. When the influences which disturb an equilibrium are of a temporary nature, such as a demand for foreign currencies to transfer capital because of fear, the new equilibrium rate tends to distort international cost relationships and to have unsettling effects

upon exports, imports, and domestic production. The adjustments which are brought about by such temporary influences may have to be undone when the rate subsequently moves back, perhaps this time too far in the other direction.

When exchange rates are moved only by government action a deliberate depreciation of the rate in order to gain foreign markets may have damaging effects upon other countries. Unless such depreciation is justified in that the new rate is close to what would be a representative equilibrium rate in a relatively free market it tends to channel trade and production away from the most economic patterns, that is, if we assume that the free market pattern ordinarily is approximately in accord with economic and social objectives. Such depreciation, particularly if excessive, causes ill-will and perhaps further competitive depreciation elsewhere. During the 1930's competitive depreciation of this kind was not uncommon. In recent years, however, the problem has been unwillingness to depreciate sufficiently.

A depreciation in the rate to promote equilibrium and the resulting increase in exports and decline in imports is accompanied by greater employment and activity in the export industries. Monetary incomes accordingly increase, not only in the export industries but generally as these incomes are spent and stimulate production of other goods. Money previously spent for foreign goods similarly stimulates domestic production and incomes as it is spent for home products. The expansion in incomes results in greater consumption and increases the demand for foreign goods. This increase in the demand for foreign goods, however, tends to check the decline in imports which was brought about by the higher exchange rate and which was contributing to the elimination of the deficit and the establishment of equilibrium. The stimulation of domestic incomes thus retards the adjustment. The increase in incomes, however, provides somewhat of an offset to the worsening of the terms of trade brought about by the rise in the rate of exchange. This subject is discussed more fully below.

Adjustments Through Movements in Prices.—When exchange rates are fixed and not free to move in response to

changes in the demand and supply of bills, the payments adjustments discussed in the preceding section cannot take place. Under the gold standard as it formerly existed currency units were defined and redeemable in fixed amounts of gold, and a currency's par value was the value determined by the gold content of the unit. The rate of exchange between two such currencies could depart only slightly from that determined by par values (i.e., the ratio between the two gold contents), since gold could be imported or exported and either currency thus converted into the other at a small cost represented principally by the cost of shipping gold. Exchange rate movements were thus confined within narrow limits on either side of the par of exchange. These limits were called the gold points and were the points where it was cheaper either to import gold rather than sell a foreign currency for less, or to export gold rather than pay more.

Although exchange rates under the gold standard could not move, except slightly, nevertheless, equilibrating adjustments came about fairly promptly. If a country's international accounts became out of balance, perhaps because of excessive imports, a balance was automatically restored so that the demand and supply of bills were equal at a rate of exchange within the gold points. These adjustments came about through changes in prices and incomes.

When exchange rates went to the gold export or import point, the resulting flow of gold set forces to work which tended to bring a balance between exports and imports, between the demand and supply of bills, at a rate close to par. If a country, for example, lost gold,—perhaps because of insufficient exports, too large imports and a consequent scarcity of foreign bills, and because exchange rates had therefore risen to the point where exportation of gold was the cheapest method of acquiring foreign currencies—the outflow of gold tended to reduce the local money supply. The loss of gold contracted bank reserves, brought higher interest rates, a slackening in bank lending and a reduction in bank deposits, since bank loans are the source of a large amount of deposits. The reduction in the monetary supply tended to lower the level of commodity prices and costs,

and also to reduce incomes, productive activity, and employment. Because of the lower prices and costs exporters were able to compete more effectively in the world market, and therefore expanded their exports. Since these exports were sold on the world market which was probably supplied by suppliers in various countries the foreign prices would be essentially unchanged. The expansion in exports increased the supply of foreign currency and thereby helped to relieve the initial difficulty.

The lower level of domestic prices meant that certain foreign goods were now more expensive than domestic goods. Imports therefore declined. Furthermore the reduction in employment and incomes resulted in less spending including spending for foreign goods, as discussed below. A country losing gold tended to have larger exports and smaller imports. As a result of the increased exports the supply of foreign bills increased whereas the decline in imports reduced the demand for bills. The effect of these changes was to lower exchange rates, within the gold points, and to check the outflow of gold. The contraction in monetary supply would accordingly cease, and exports and imports would be in an approximately balanced position at the prevailing exchange rate. These forces continued so long as the gold outflow continued and the unbalanced condition persisted.

An inflow of gold had reverse effects to an outflow. Countries which received gold tended to have larger bank reserves, an expansion in the monetary supply, higher price levels, employment and incomes. Higher domestic prices meant that certain foreign goods became cheaper than domestic goods so that imports increased. Expanded employment and larger monetary incomes also encouraged imports. Exporters found that the higher domestic costs cut into the profit of their exports; also that the domestic market was more attractive. Exports declined. The effect of these movements was to reduce the supply of foreign bills, to increase the demand and to raise the rate for foreign currency so that gold imports ceased.

These monetary and price movements, known as the price-specie-flow mechanism, tended to bring equilibrium between total export and import transactions at the fixed rate of ex-

change. The adjustments in the balance of payments thus came about not as a result of exchange rate movements but through changes in prices, employment and incomes.

In these price level (and also exchange rate) adjustments it is the relationship of the price level for domestically traded goods to that for internationally traded goods which ordinarily changes. The influence of price changes in a single country (or of higher or lower prices to foreigners because of an exchange rate adjustment) on the prices of internationally traded goods is not likely to bring about much of a change in the latter since internationally traded goods are demanded and supplied by many countries. For example, if a country's exchange rate declines (foreign currencies more expensive), its export commodities, which are sold in the world market, generally continue to be sold abroad at approximately the same prices as before. The country's exporters, however, receive more local money for their bills and therefore endeavor to expand their exports and obtain a larger share of the world market. They may cut prices slightly but will probably not need to lower them very much to gain a larger share of the market. Conversely, internationally traded commodities become more expensive to the country with the depreciated exchange rate and their importation is reduced. Similarly, as a country's domestic price level rises or falls, internationally traded commodities become to it relatively cheaper or dearer, and imports or exports expand or contract. It is thus the relationship between the prices of internationally traded goods and a country's domestic prices which changes and thereby promotes equilibrium.

Under the gold standard the adjustments in prices to a fixed exchange rate followed this pattern of little change in the prices of internationally traded goods, but of an altered relationship between these prices and those of domestic goods. An import of gold and consequently higher domestic prices, encouraged increased imports of goods and brought a greater demand for foreign currencies, which tended to restore a balance in the demand and supply of bills. A reduction in exports because of higher domestic costs, and lower prices abroad in countries losing gold, also contributed to the adjustment.

It will be noted that while the flow of gold into and out of the different countries brought about adjustments necessary to achieve equilibrium in the balance of payments, these adjustments required movements within a country's domestic economy that might have disturbing consequences such as unemployment, lower incomes, and unstable prices. Domestic prosperity and stability might have to be sacrificed to balance of payments equilibrium at the prevailing exchange rate.

After the first World War governments began to regulate the money supply and prices in the interests of domestic stability. A loss of gold was offset by central bank action to prevent credit contraction and a reduced money supply. The central bank, for example, might lower its interest rates so as to make it cheaper for commercial banks to borrow at the central bank and thereby expand their reserves and be able to make more loans to their customers. Increased bank lending would increase deposits which are part of the country's money supply. The central bank might also purchase securities in the open market and thereby put additional money into the economy, particularly in bank reserves where it would stimulate bank lending and an expansion of deposits. Conversely, a receipt of gold might be "sterilized" by the central bank and prevented from causing an expansion in the money supply.

These measures, while they tended to promote internal stability of prices, employment, and incomes, interfered with the attainment of a balance in international accounts, and thereby contributed to the situation wherein the prevailing fixed exchange rates could not be maintained. Countries were sometimes thus confronted with the choice between fixed exchange rates and internal economic stability. They usually chose the latter. The effectiveness of government fiscal policies, however, in promoting internal economic stability is probably not as great as was believed at that time, as will be discussed in the next section.

Adjustments Through Movements in Income.—Prior to the latter part of the 1930's balance of payments adjustments

were considered to come about almost entirely through alterations in the exchange rate and through movements in prices. The price-specie-flow analysis was at the heart of the explanation of the balancing process for countries on the gold standard. For countries not on the gold standard exchange rate movements were considered responsible for the necessary adjustments. It is now recognized that major changes in exports and imports are brought about through the expansion or contraction of monetary incomes both at home and abroad, and that these movements frequently account for the bulk of an adjustment which takes place in the balance of payments. Such movements in incomes may, however, under certain conditions be the source of disequilibrium in international accounts.

If a country has an increase in its exports, for a reason independent of changes in incomes, perhaps because technological improvements have created a greater foreign demand for its products or because it has made a loan in its currency to a foreign borrower, the country, as a result of the increased exports, may have a lack of balance in its international accounts. Accompanying the expansion in exports will be greater activity in the export industries, which will lead to increased employment and incomes in these industries. There will also be a greater demand for materials utilized by these industries. The increase in employment and incomes will not be confined to the export industries, but will spread throughout the entire economy as orders are placed for materials, as workers spend their incomes, and as merchants replenish their stocks. Unless the country's labor force and other productive resources are fully employed, there will be a net increase in employment and in monetary incomes in the country, and an increase in the demand for goods and services. The increased spending includes larger purchases of imported goods, both for final consumption and for further production. The resulting increase in imports tends to offset the initial increase in exports and thereby promotes a balance in the country's international accounts. Statistical studies have confirmed this reasoning and have shown a close correlation between movements in incomes

and movements in imports. When a country's incomes increase, its imports also increase. This subject is discussed further in the next chapter.

The initial increase in exports would cause the country to receive gold or foreign currencies in payment for the additional goods sold abroad. The gold and foreign currencies received would be converted, probably at the central bank, into local currency so that the local monetary supply would increase promptly. The expansion in monetary supply, which would also come about through increased bank reserves and lending, would tend to expand incomes and employment which, as noted above, would cause an increase in imports, thereby further facilitating a balance in the country's accounts. The expansion in incomes is thus brought about both by greater activity in the export industries with a resulting greater demand for goods and services, and also, more slowly and probably to a less extent, by an expansion in the money supply due to the receipt of funds from abroad. The expansion in incomes brought about by the additional money and the resulting stimulus to imports is not to be confused with the stimulus to imports from higher domestic prices which would be likely to accompany, but not necessarily, the spending of the new money. An influence contributing to the adjustment is the fact that the activity in the export industries and in the economy generally would tend to result in greater bank lending and therefore an expansion of the money supply apart from that due to payments from abroad.

As a result of the initial increase in exports foreign countries necessarily receive more imports from the exporting country. Countries receiving these imports might pay for them with gold or by drawing down their balances in the exporting country. The effect of these payments on the importing countries would be a contraction of their bank reserves and monetary supply, which would lead to reduced economic activity and lower incomes and employment, which would in turn tend to check their imports. The situation would be somewhat the reverse of that in the country with increased exports. The resulting tendency toward lower imports in the foreign countries accompanying the reduction in incomes and employment would contribute to

restoration of a balance in international accounts. Moreover, the initially increased imports might replace the consumption of similar domestic products or divert spending from domestic to imported goods. To the extent that this replacement or diversion took place it would reduce local production, incomes, and employment, which would in turn cause a decline in imports thereby promoting a balance.

Movements in incomes may, of course, have their origin elsewhere than in an expansion of exports, and may cause an increase in imports not needed for a balance in international accounts. When a country has an inflation of its currency, monetary incomes and employment are increased and the resulting expansion in imports may cause a disequilibrium in the balance of payments. Additions to the monetary supply tend to bring an increase in economic activity generally and greater consumption on the part of the recipients of the larger incomes. If the country's productive resources are already fully utilized, which is unlikely, the increased money would cause a more rapid rise in prices than otherwise; but in either event, whether the effect of the new money is to increase output or to raise prices or both, monetary incomes would tend to be greater than before and consumption would expand. The effect of this expansion in incomes and consumption would be to cause an increase in imports. Such an increase in imports, however, was not needed to bring a balance in the country's accounts, and, on the contrary, may create a disequilibrium. An increase in the monetary supply and a consequent increase of incomes and employment may by expanding imports thus bring a deficit in the balance of payments, a common occurrence in many countries. A further analysis of the effects on incomes and foreign trade of increases in the monetary supply is contained in the next chapter on "National Income and the Foreign Trade Multiplier."

If a country continues to have inflation and maintains a fixed rate of exchange the deficit in the balance of payments will persist so long as the inflation lasts and will be made still larger by the high costs of the country's goods in comparison to those of foreign goods where price rises have not taken place or have been less. Governments which continue to have budgetary

deficits financed by inflationary means frequently are confronted with this problem. The deficit in the balance of payments may necessitate sooner or later a change in the exchange rate in order to make imports more expensive and thereby curtail them and to make exports cheaper to foreigners and thereby expand them. A country may, of course, be able to finance a deficit for a considerable period by drawing down its foreign balances, shipping gold, or borrowing abroad, or it may resort to a limitation of imports through control devices.

If no fixed exchange rate is maintained the rate will decline as inflation proceeds, reflecting prevailing and anticipated price and income relationships as expressed through the current demand and supply of bills. If monetary incomes continue large because of inflation, the resulting enlarged imports may require a relatively low rate of exchange in order to bring equilibrium. A lower or depreciated rate means that the terms of trade are less favorable, that is, a larger volume of local goods must be given in exchange for foreign goods since local money buys less foreign money than it would if the equilibrium rate were higher.

Movements in incomes do not necessarily bring complete equilibrium in the balance of payments, and in some circumstances may bring disequilibrium as noted above. An increase in exports which creates an imbalance may be offset to a large extent and perhaps fully by greater imports as a result of expanded incomes, regardless of whether the exchange rate is fixed. There is no assurance, however, that the magnitude of the increase in imports will conform precisely to the increase in exports. If the disturbance is an excess of imports and a resulting deficit in the over-all balance of payments (due perhaps to an increased demand for foreign goods because of a too high exchange rate for local money), corrective income movements, i.e., a contraction in incomes, may not take place or at least take place to an extent sufficient to correct the disequilibrium. The enlarged imports may offer competition with local goods and cause some decline in local production and incomes, which would thereby tend to reduce the excessive imports as spending is curtailed. The outflow of funds to foreign countries to pay for the

enlarged imports would also tend to cause a contraction in monetary supply which would likewise help to reduce imports.

There is no assurance, however, that these events would take place on a scale sufficient to restore a balance in international accounts. The imports might be an addition to existing consumption rather than a replacement of local goods, and they might be paid for by borrowing abroad, so long as this is possible. When sources of foreign borrowing are exhausted the country may have an import deficit requiring an exchange rate adjustment, or the deficit may lead to the placing of restrictions on imports with their consequent evils. Income movements may therefore create a disequilibrium, depending largely on their origin, and cannot by themselves be counted on to provide a complete adjustment in the balance of payments.

If the lack of balance in a country's international accounts is caused by capital transfers or other events which do not affect incomes, except perhaps indirectly, there will be little or no adjustment arising automatically out of the disturbing event. If there is, for example, a strong demand for foreign currencies in order to transfer capital, and consequently pressure on the exchange rate, this condition does not lead to a contraction in incomes and employment, and therefore in imports, except as the local monetary supply may be reduced as money is presented for the purchase of foreign currencies. Adjustments in this manner are slower than those arising out of an expansion or contraction in the export industries and an increase in the demand for goods.

If a country receives capital and therefore has a surplus in its balance of payments the stimulus to incomes and consequently to imports from an expansion of the money supply is similarly slower than the stimulus which would arise were the surplus due to enlarged exports. Disturbances in the balance of payments can thus set forces in motion to restore or help to restore equilibrium through movements in incomes only as they affect the circular flow of money and thereby alter incomes and accordingly exports or imports. The magnitude of such adjustment may or may not conform to that needed to bring a balance. This question is discussed further in the next chapter.

Adjustments and Economic Stability; Fixed versus Flexible Exchange Rates.—Under the gold standard as it existed prior to the first World War, exchange rates remained fixed and were subject to only minor variations from par. Adjustments in the balance of payments were brought about almost exclusively through movements in price levels and in incomes and employment, except under extreme conditions when a country was forced to suspend gold payments and permit exchange rates to depreciate. The balancing process was automatic and usually functioned with promptness and completeness; in fact, the smoothness and rapidity of adjustments sometimes surprised economists who believed at that time that the price-specie-flow mechanism was entirely responsible for adjustments in the balance of payments. This was the situation which prevailed down to the outbreak of war in 1914 when the gold standard was largely abandoned.

While adjustments took place under the fixed rates, they were accomplished at the expense of internal economic stability, notably fluctuations in prices, investment, employment, and general prosperity as noted above. A country losing gold would be subjected to deflation, falling prices, unemployment, a decline in incomes, and a depressed state of business generally. These conditions would bring about the needed decline in imports and expansion in exports. A country receiving gold, on the other hand, would enjoy larger incomes and prosperity, at least temporarily, and would have an expansion of imports and a decline in exports. The additional gold might lead to an inflationary boom, accompanied by speculation, overexpansion of industry and subsequent collapse. Most countries considered maintenance of free gold payments and the exchange rate at its fixed official level a matter of prime importance, vital to the country's economic well-being and prestige, and an indication of soundness. Depreciation of the rate of exchange and the inauguration of fluctuating rates, entailed a loss for certain individuals (a profit for others), and introduced difficulties into the conduct of foreign trade and financial transactions. Uncertainties as to the rate of exchange which would prevail introduced hazards into international lending and other transac-

tions. In spite of these possible losses and other difficulties, maintenance of the official rate acquired an importance in the eyes of the public greater than was justified on economic grounds. Suspension of gold payments and resulting departure of the rate from par involved a shock to public confidence and to the government's prestige which governments desired to avoid at all costs.

Largely for these reasons countries tolerated economic instability in order to maintain a particular fixed exchange rate more or less permanently and enjoy the accompanying advantages, real and imagined. It is also true that during the period of the pre-1914 gold standard there was little understanding of the relation of fixed rates and gold movements to unemployment and economic disturbances. Economists were concerned over movements in the price level and the effect upon debtors, creditors, and persons with fixed incomes, and had not yet developed an analysis which related income movements and general economic instability to gold flow and monetary matters. This analysis did not come until the 1930's.

Governments began during the 1920's to endeavor to stabilize internal price and credit conditions through central bank actions. They sought at the same time to maintain fixed exchange rates and were not aware, except vaguely, of possible inconsistencies. Central bank actions, aiming particularly at stabilizing the level of prices insofar as this was considered feasible (but the aim not being officially announced), endeavored to offset increases or decreases in the monetary supply. An outflow of gold and decline in reserves might thus be accompanied by central bank purchases of securities in the open market designed to replenish commercial bank reserves, and perhaps by a reduction in the central banks' rate of discount so as to encourage commercial bank lending and promote an expansion of deposits.

Such central bank actions tended to counteract the movements in prices and incomes resulting from the flow of funds in or out of the country, but did not affect materially the balance of payments adjustments brought about through income movements and changes in output and employment that resulted di-

rectly from changes in the demand for goods. The expansion in incomes and employment following activity in the export industries would thus not be checked substantially by central bank actions designed to neutralize an inflow of gold.

Such movements in incomes and employment, caused by changes in the balance of payments, may be seriously disturbing to the domestic economy. Balance of payments adjustments brought about by income movements without the aid of exchange rate realignment may therefore require internal instability.

A country with a deficit in its balance of payments, and maintaining at the same time a fixed exchange rate, may have to choose between a lower rate which would facilitate an adjustment, causing foreign goods to be more expensive and domestic goods cheaper to foreigners, or a lower level of incomes and employment attained through deflation. The latter course is usually not feasible politically even if it were economically desirable. A third possibility, of course, is a limitation of imports by the imposition of restrictions, including restrictions on the purchase and sale of foreign currencies. Such a course, however, has serious disadvantages, except perhaps as an emergency measure under special circumstances as discussed below, and is not conducive to a world-wide expansion of production and trade.

If a country endeavors to pursue a policy of domestic economic stability and to maintain a high level of incomes and employment, as most countries undertake to do, disturbances which arise in the balance of payments will in many instances have to be provided for through changes in the rate of exchange. Large gold reserves or foreign balances may, of course, permit a country to defer a rate adjustment in the hope that conditions may change and obviate the necessity of such an adjustment. Movements in internal prices and resulting changes in relative costs between different countries may cause an unbalanced situation which similarly can be dealt with effectively only through a change in the rate of exchange.

Inasmuch as movements in incomes and employment ordinarily account for a substantial part of the adjustment which

brings equilibrium in the balance of payments, a policy of domestic economic stability in which such movements are largely absent leaves a change in the exchange rate as practically the only adjusting device. A further possibility consists in real changes in production and demand, which, however, can ordinarily be accomplished only slowly and to a limited degree as a solution to balance of payments maladjustments. When income movements have caused disequilibrium an exchange rate adjustment may be the only feasible solution since a retracing of steps is neither practical nor desirable. To the extent that governments succeed in policies of internal economic stability, there should be less disturbance in their balance of payments relationships, and consequently, less need for exchange rate adjustments; but such a goal has not yet been attained.

It has been proposed that governments undertake to make frequent adjustments in rates, perhaps every few months, or that they permit the rate to move gradually where it will, preventing only the day to day or other short-term fluctuations. While the uncertainties of a flexible exchange rate entail difficulties for trade and financial transactions it has been urged that business is accustomed to domestic price and cost changes and can adapt itself to gradual exchange movements with less harm to the economy than comes from inappropriate fixed rates.[1]

If a country maintains a rate of exchange so high as to discourage exports, the depressing effect of the reduced exports on incomes and employment may, under certain circumstances, decrease imports to a point that equilibrium in the balance of payments exists, but at a low level of output and employment.[2] Such a situation is unlikely to continue long and in most instances where a high rate of this kind exists imports are stimulated by the cheapness of foreign goods, and a lack of balance is

[1] The questions of fixed versus flexible rates, exchange rate adjustments and their relation to equilibrium are discussed further in Chapter 24, "Monetary and Exchange Problems—Position of Gold."

[2] Great Britain in the latter half of the 1920's suffered from an overvalued pound which discouraged exports and was accompanied by unemployment and depression. A balance in the country's payments was maintained for a considerable period without exchange restrictions, but at a reduced level of income and prosperity.

created in the country's international accounts. Import or exchange restrictions are then commonly imposed in an effort to check the excessive imports and to achieve a balance at the prevailing rate.

Trade today takes place to a large extent as a result of government decisions with respect to its direction, type, and volume. Equilibrium under such controlled conditions may be quite different from what it would be were there no controls. Under the prevailing system of controlled economies, wherein governments regulate to a considerable extent exports and imports, the balance of payments is in a sense whatever the government chooses to make it, depending upon the extent and effectiveness of government controls and of government foreign trade activities. A deficit may exist because the government itself makes large purchases abroad, perhaps as part of an extensive import program. The rate of exchange that is maintained through regulatory devices may not promote equilibrium but disequilibrium. Nevertheless a balance may be brought about by the limitation of imports.

Governmental measures of this nature, regardless of their economic merits or demerits, tend to interfere with the automatic adjustments in the balance of payments described above. An equilibrium under the prevailing economic systems may be achieved through various means, but the level of economic activity, the volume of production and trade, and their adaptation to consumers choices may be different from what they would be under a different set of conditions.

Chapter 9

NATIONAL INCOME AND THE FOREIGN TRADE MULTIPLIER

Multiplier Principle.—Since the latter part of the 1930's considerable attention has been given to the effects upon prices and the national income of additions to a country's supply of money. This analysis led to the development of what is known as the multiplier principle. This principle deals with the effects upon a country's national income of an injection, or series of injections, of new money into the monetary circulation. Inasmuch as an injection of new money ordinarily increases incomes by more than its absolute amount before its stimulating effects disappear, the principle is referred to as the multiplier principle.

It was noted in a previous chapter that the expenditure of new money does not necessarily lead to a rise in prices but may on the contrary lead to increased output of commodities or services. The additional spending, instead of being directed toward a fixed stock of commodities and, therefore, tending to bid up their prices, may and in fact probably will bring about an expansion in production and employment. As stocks of goods are depleted accompanying the additional spending, new and larger orders are placed by storekeepers because of the increased spending. Factories employ additional workers, who in turn spend more money as their earnings have become greater. The stimulating effects of the additional monetary disbursements spread throughout the economy.

Such an expansion of production, employment, and incomes is possible only when there exist unused resources and labor. As full employment is approached and further expansion of physical output becomes increasingly difficult, prices rise more rapidly accompanying the spending of the additional supplies of

money. If large and continuing amounts of money are put into circulation, practically the full effect will eventually be to raise prices with little or no increase in output.[1] When such a point of full employment is reached, though output does not expand further, monetary incomes continue to increase. A condition of full employment is, of course, not a precise point but a flexible limit that is stretched as inducements for further production become greater, so that a condition is seldom reached wherein no further expansion is possible. High wages, for example, attract workers who would otherwise not be interested in working. The essential point is that the expenditure of additional supplies of money tends to increase the national income by stimulating production and employment of workers.

An injection of new money into the monetary stream or the reactivation of existing but idle money usually increases the national income by more than the absolute amount of such money, because the money is ordinarily spent more than once. The new money may have originally arisen out of a bank loan perhaps made to finance some investment project, and may have been spent in part for wages of workers, for materials, etc. Similarly with respect to reactivated money. The workers receiving the money spend their earnings in part for consumption goods, for payments on debts, and for a variety of other purposes, perhaps putting some of the money into their savings accounts or hoarding it at home. The money that is used to pay off debts or to add to savings is, at least for the time being, out of the monetary stream and has no further effect on production or incomes. Such money, including that which is invested, may be held idle for a considerable period of time, so for present purposes is regarded as out of circulation. When it is expended again it may be regarded as a new injection of money. As the other money is spent and respent, some of it at each stage is similarly being drawn off from circulation, while a constantly declining amount goes on and on until eventually the remaining amount becomes infinitely small and for practical purposes is zero. These amounts that become lost to the monetary stream

[1] An extreme inflation, however, causes so much economic disorganization that output may decline.

are called leakages and eventually comprise practically the full amount, at which time the stimulating effects of the new injections of money have disappeared.

In the spending and respending of the money some of it is received by the recipients in the form of income, whereas other portions are to them reimbursements for business expenses and are paid out by them for business costs. These portions are not income. For example, the receipts of a retailer must be used by him largely to replenish his stocks and to pay rent, wages, and other expenses. A portion, however, represents income to him, unless the business is a failure in which case it will eventually have to disappear. The expenditures that are for the wages of workers are, of course, income to them. Similarly the expenditures for inventories and other business costs are partly income to the recipients, but not to the retailer. The new money thus continues to increase incomes as it goes on and on, but by a declining amount each time.

It was noted in the previous discussion that in the spending and respending of money the length of time for money to complete a circuit from one income recipient to another income recipient is called the circular or income velocity of money. It is usually referred to in terms of the number of times during a given period, e.g., a year, that the circuit is completed. This figure is not the so-called multiplier, which refers to the number by which an injection of new money must be multiplied in order to equal the total amount by which incomes are eventually increased. For example, if an injection of $100 of new money increases incomes by $300, the multiplier would be three. At the same time the rate at which money circulates may be such that six months are required on the average for a dollar which is received as income to be received again as income. In this case the income velocity would be two times a year.

Multiplier analysis concentrates attention on expenditures for consumption, since it is these expenditures that are the driving force behind production and that in the last analysis account for the size of the national income. Goods and services are produced in order to increase final consumption, and the productive process endeavors to adjust itself to the volume of consumption

desired by the consuming public. When it fails to make a satisfactory adjustment economic instability results. The volume of consumption is therefore important in multiplier analysis. If the propensity of the public to consume is relatively high, a large portion of the income resulting from an injection of new money is spent for consumption rather than being saved or otherwise drawn off. The multiplier would then be relatively high with an accompanying large increase in incomes as a result of the injection of the new money. If little of the new money, however, is spent for consumption most of it would disappear from the monetary stream and the multiplier would be low.

A single injection of money exhausts its stimulating effects before very long due to the leakages noted above. If the effects are to be maintained, therefore, a continuing series of new injections is necessary. The table below illustrates with figures the working of the multiplier principle. It is assumed that $100 of new money is disbursed in each multiplier period, and that of this sum one-half is spent in the succeeding period on consumers goods and the other half is lost through leakages. The marginal propensity to consume, referring to the amount of each additional increment of income which the public desires to consume rather than to save or invest, is, therefore, one-half.

TABLE 8

ILLUSTRATION OF MULTIPLIER PRINCIPLE
(dollars)

Period	Amount of Each Injection of Money	Amount Respent in Successive Periods							Total Leakage	Total Spent
1	100									100
2	100	50							50	150
3	100	50	25						125	175
4	100	50	25	12.5					212.5	187.5
5	100	50	25	12.5	6.25				306.2	193.8
6	100	50	25	12.5	6.25	3.13			403.1	196.9
7	100	50	25	12.5	6.25	3.13	1.56		501.5	198.5
8	100	50	25	12.5	6.25	3.13	1.56	.78	600.8	199.2

In the above illustration it will be noted that the multiplier is two. Thus the initial expenditure of $100 and the declining portions of this which are expended for consumption in each succeeding period (reading diagonally downward 25, 12.5, 6.25, etc.), eventually total approximately $200 or twice the amount of the injection. If there were only one injection, the resulting increase in the national income amounting to almost $200 would soon disappear. On the other hand, successive injections of $100 with a multiplier of two would provide a continuing increase of about $200 in the national income. In the eighth period the total is made up of the eighth injection of $100, plus $50 remaining from the seventh, $25 from the sixth, $12.50 from the fifth, etc., amounting in all to almost $200. It will be noted that if the leakage at each period were only one-third instead of one-half the multiplier would be three. The multiplier is thus the reciprocal of the leakage.

Autonomous and Induced Changes in Foreign Trade.— The multiplier process is closely related to movements in a country's foreign trade and to its balance of payments. Inasmuch as the effects of income creating expenditures differ depending upon the nature of the expenditure (e.g., government expenditures, private investment, etc.) there are different kinds of multipliers, one of which is known as the foreign trade multiplier. It refers to the multiple effects on a country's economy from injections of money that arise out of an increase in exports. For example, if, perhaps because of a new discovery, a country's exports increase, such a country's exporters receive additional sums of money from the foreign purchasers. This money is thereupon spent by the exporters and respent by the recipients again and again with consequent stimulating effects upon the economy and upon incomes as noted. From the standpoint of multiplier analysis these receipts by exporters constitute injections of new money.

In order to distinguish original, independent, or spontaneous changes in exports and imports from the changes in such trade brought about or induced by injections of money, the former are referred to as autonomous or primary changes, whereas the

latter are known as induced or secondary changes. An autonomous change in foreign trade is one that takes place independently of changes in domestic incomes. Induced or secondary changes in foreign trade, on the other hand, are those which are the result of changes in domestic incomes. For example, an increase in imports may take place because of greater prosperity and larger incomes in the hands of the home public. This would be an induced change in imports. Autonomous changes in foreign trade, on the other hand, result from such things as changes in the preferences of consumers (foreign consumers in the case of exports and domestic consumers in the case of imports), in the techniques and methods of production, in tariffs and government regulations, and in transportation costs and facilities.

Exporters may be able to sell more goods abroad than formerly because foreigners have come specially to desire the type of goods we produce, or perhaps because foreign countries have suffered a crop failure and need our agricultural products, or because of political disturbances abroad or the devastation of war. Whatever the reason, we may assume by way of illustration that an autonomous increase in exports has taken place. Exporters therefore receive larger sums of money which are paid to them by foreigners. This money may come from deposit balances which foreigners own in this country and which were idle, from gold shipments to us, from borrowings in this country by foreigners, or from various other possible sources. The exporters proceed to spend the money partly for business costs, such as to buy goods for further export, or to pay wages, and partly for their own consumption. A portion of the money is income to them and thus available for consumption or other purposes as they may choose. Some of the money may be saved and thereby become a leakage. As outlined in the previous section the new money stimulates domestic output and increases employment and incomes as it is spent and respent. The increase in incomes is greater than the absolute amount of the additional receipts from exports, i.e., the injections of money, the number of times by which it is greater being the foreign trade multiplier.

The increase in incomes that is brought about by the multiple effect of the receipts from larger exports is spent not only for domestic goods but a portion is also spent for foreign goods. Foreign goods constitute directly or indirectly a substantial portion of the goods purchased by practically everyone. The foreign goods purchased are not only consumer goods, but the enlarged domestic output requires the import of additional amounts of various foreign raw materials and other products. A secondary or induced effect of the additional money and of the expanded incomes is therefore an increase in imports.

An increase in imports, however, has effects on output and incomes which are the reverse of an increase in exports. Larger imports require larger payments to foreigners, and are therefore in effect a deduction from the receipts arising out of the autonomous increase in exports, as viewed from the standpoint of the net effect of such export receipts upon incomes. While receipts from the additional exports are an injection of money, payments for the induced imports constitute an ejection of money and are depressing in their immediate effects upon output, employment and incomes.[2] In multiplier analysis payments to foreigners for imports are considered one of the leakages.

A further consequence of the expanded incomes at home is an increase in the amount of domestic savings. People ordinarily save a larger percentage of their incomes as these incomes increase. When incomes decline people are able to save less and may even consume a portion of their previous savings. As incomes improve, however, they pay off debts and otherwise save. The increase in savings accompanying larger incomes is another leakage, and like an increase in imports tends to counteract the stimulating effects of the injections of money arising out of an autonomous increase in exports. Larger imports and larger savings are thus two important leakages.

While incomes at home have been increased by the rise in exports, in the foreign countries receiving these exports the

[2] Such a statement is, of course, not to be construed to mean that imports are undesirable and should be minimized. The desideratum in foreign trade is a large and balanced export and import trade based on comparative advantages in production and free consumers choices. It is also to be remembered that imports to us are exports to foreigners.

tendency is for incomes to decline. In the foreign countries imports are larger than formerly and therefore payments to foreigners are also larger. These payments constitute ejections of money and have an effect on output and incomes opposite to that of injections of money. With lower incomes in the foreign countries because of the increased imports, foreigners tend to buy less from us than otherwise so that the rise in our exports is reduced somewhat by this counter force.

In the foreign countries receiving our exports, where incomes have decreased because of the increased imports, the rate of saving tends to decline, since savings tend to increase or decrease along with incomes. A larger portion of incomes is thus spent for current consumption than formerly, because of the reduction in savings. As a consequence, the depressing effects on incomes of the enlarged imports are thereby lessened. Inasmuch as the rate of savings abroad declines, and thereby checks the reduction in incomes there, the foreign countries' imports from us are accordingly not reduced by as large an amount as would be the case if the rate of saving abroad remained constant. The repercussions on foreign countries growing out of the original increase in our exports thus have further repercussions on our economy, and so on, back and forth in constantly declining volume as a position of stability or balance is sought by these economic forces.

These repercussions on foreign countries resulting from our increased exports take place in response to conditions there which differ from country to country. The rate of savings at home and the rate in foreign countries are doubtless not the same, each depending upon the propensities of the respective publics to save. Propensities of the public to consume or to save, to buy foreign as opposed to domestic goods, or to invest their savings at home or abroad, vary from country to country, so that the multiplier in our country is probably not the same as the multiplier in other countries where these propensities are different.

The forces described above may be summarized and set forth in the form of an equation. The substance of this equation is as follows:

$$\text{Increment in money income} = \frac{\text{autonomous increase in exports}}{\text{leakages as decimal}}$$

On the basis of the following symbols the formula is as noted below:

$Y =$ increase in money income of exporting country
$X =$ autonomous increase in exports
$m =$ induced imports
$s =$ induced savings
$f =$ repercussions from effects on other countries
$k =$ multiplier

$$\mathrm{Y} = \frac{\mathrm{X}}{m + s + f}$$

Assume an increase in exports of \$100 and a leakage of .30% due to induced imports, .15% due to savings and .05% due to repercussions in the foreign country. If we insert figures the result is as follows:

$$\$200 = \frac{\$100}{.30 + .15 + .05}$$

The multiplier is two and the increase in income resulting from an increase in exports of \$100 is thus \$200.

It will be noticed that, conversely, a decrease in autonomous exports would result in a decrease in money incomes of the exporting country, and that the other factors would also be reversed.

The formula for the multiplier, it can be seen, is:

$$k = \frac{1}{m + s + f}$$

Inserting figures the result is:

$$2 = \frac{1}{.30 + .15 + .05}$$

Monetary Expansion and Foreign Trade.—Injections of money into the monetary stream of a country commonly take place not only because of an increase in exports but because of such things as government deficit financing or increased business borrowing from banks. Injections of money arising out of increased exports are only one of the many possible sources of monetary expansion. Governments may purposely expand the money supply in order to stimulate employment and economic activity and to counteract depression. Regardless of the reasons for the monetary injections their effect is a tendency toward increased output and larger incomes as noted above.

The increase in domestic incomes accompanying an inflation of the monetary supply leads to larger imports from abroad, and if the monetary expansion is extensive and long continued may cause a deficit in the country's international balance of payments. Many countries have suffered an imbalance in their international accounts as a result of domestic monetary expansion, inflated incomes and ensuing larger imports. Especially in the postwar period when government revenues fell behind current needs, was monetary inflation a major contributory factor in balance of payments difficulties. The effects of monetary expansion on the balance of payments, and the means by which equilibrating adjustments are brought about to overcome resulting disturbances, were discussed in the previous chapter.

The increased expenditures of the public on imported commodities, accompanying monetary expansion and larger incomes, constitute a leakage and tend to retard the multiplier effects of the injections of money whatever the reason for these injections, whether they result from larger exports, government financing, bank lending, etc. The expansion of imports thus lessens or retards the increase in the national income. Increased domestic savings also weaken the stimulating effects of the additional monetary disbursements and thereby similarly reduce the increase in incomes.

The foreign countries from which we import more than formerly, as a result of the domestic monetary injections (perhaps from deficit financing), have larger exports and therefore experience the consequences of what was described above as an

autonomous increase in exports. Their incomes accordingly expand and as a consequence, since a portion of their incomes is spent for foreign goods, they in turn import more from us. Their purchases here, which to us are an increase in exports, (an induced increase traceable to our enlarged incomes), tend to reinforce the stimulating effects of the original monetary injections in this country. The higher the propensity of foreigners to consume, especially imported goods, and the more they purchase from us, the higher will be the multiplier applicable to the injections of money here. The more they purchase from us, however, the larger is the leakage in the foreign countries, since imports are to them a leakage, and the lower is the multiplier there. The larger their imports and the lower their multiplier, the less stimulation to incomes abroad resulting from our increased purchases in foreign countries following our expansion of the money supply.

Another leakage in the foreign countries which affects the extent of their income expansion is the increased saving there accompanying the larger incomes in such countries. The increase in savings in the foreign countries retards the expansion in incomes there.

The Multiplier and Equilibrium.—When incomes in a country rise following a continuing series of injections of money, or fall following ejections of money, foreign trade is affected as noted above. The question arises as to whether these changes in exports and imports tend by themselves to result in an equilibrium, with respect to their own particular amounts, or whether maladjustments are created that must be corrected by other means. The initial changes and the repercussions on foreign countries, which in turn react upon the original country, are, of course part of the country's total international payments position. The immediate question is whether these changes are self-equilibrating or whether they require exchange rate or other adjustments in order that equilibrium may be established.

It was noted in the balance of payments discussion that an increase in exports tends to result in an increase in imports, and

vice versa. Exports provide a country with the foreign currency which it needs to pay for larger imports. Similarly, the ultimate effect of an increase in imports may be an increase in exports since the money paid to foreigners will probably eventually be spent by them for our goods or services. The money, however, may be held idle by foreigners for a considerable period of time and have little immediate effect upon exports. It may be used to increase foreign exchange reserves. Moreover, some of it may be used to retire debts owed to us, and may thereby disappear from the monetary circulation, except as the creditors here may utilize all or part of it for income creating expenditures, in which case it would be treated as a new injection in multiplier analysis.

With respect to a particular import transaction foreigners may be paid in our money for their shipments to us, or they may be paid in their own money. Similarly, exporters may receive our money or may be paid in foreign money. The method of payment, however, should not be allowed to confuse the effects of the transaction. Regardless of payments arrangements, imports provide the wherewithal for and make possible larger exports, and similarly exports make possible larger imports as previously discussed.

The effects of an import transaction on further exports, and vice versa, however, are largely permissive. It does not necessarily follow that because foreigners have more of our money they will always buy more of our goods. The propensities of the public to purchase domestic or foreign goods, to consume or to invest their incomes, and to invest at home or abroad, and the reflection of these in government policies largely determine the extent to which the proceeds of exports are actually used for imports and vice versa. The proceeds from an export transaction may thus be used by the public immediately to purchase foreign goods, they may be held, invested abroad or used for some other purpose.

Decisions to consume foreign goods, to invest abroad or to use foreign funds for some other purpose are made almost entirely independently of the supply of foreign currency except as government regulations may otherwise determine. Consumers

with larger incomes thus may decide they want more of a certain article, and this article may come from abroad. These decisions ordinarily are not related to the availability of the needed foreign currency unless the scarcity or abundance of such currency is reflected in the cost of the article. An increase in the supply of such currency, however, due to larger exports, may not have caused an appreciable change in the rate of exchange and may, therefore, not be a factor in the cost or in the public's decision to buy more or less of the article in question. Eventually, of course, a depletion in the supply of such currency must assert itself either through the imposition of exchange restrictions or through higher rates of exchange. Similarly an excessive supply will doubtless eventually affect the exchange rate and the cost of foreign goods.

In the case of an autonomous rise in exports, the tendency toward larger imports accompanying a resulting increase in domestic incomes creates a demand for foreign exchange, but the supply of foreign exchange in this instance has probably been increased by an even greater amount due to the enlarged exports. The portion of the increased incomes used to buy additional foreign goods would likely be much smaller than the rise in exports, unless the multiplier were extremely high (which would thereby reflect a very large increase in incomes) and unless the propensity to consume foreign goods were also extremely high. An autonomous increase in exports, therefore, tends to result in a net increase in a country's exports over imports, and to strengthen rather than weaken a country's foreign exchange position. The repercussions in foreign countries would reduce somewhat the net increase in exports but would not be likely to eliminate it since if this were to be the case there would need to be extreme repercussions in the foreign countries such as a drastic decline in incomes there accompanying the increased imports.

In order that the changes in exports and imports and their repercussions may bring an eventual equilibrium with respect to their particular amounts, the total effect of the leakages must exactly offset the other effects of the injections of money. For example, an autonomous increase in exports of $20,000,000

per period might decline to $15,000,000 in a subsequent period as foreign countries' incomes are reduced due to their increased imports (allowing also for the effects of a lower rate of savings abroad). Our imports, a leakage, would then need to increase (brought about by our larger incomes and allowing for greater savings here) by $15,000,000 if equilibrium is to exist with respect to the affected segment of our foreign trade. Similarly, if, due to domestic monetary expansion, our imports are increased by $10,000,000 per period foreign purchases of our goods (accompanying the larger incomes abroad and greater availability of dollars) would then need to rise by $10,000,000 if equilibrium is to be established between the changes in our imports and exports as a result of the monetary injections.

Such a large increase in exports as a result of our expanded imports, and apart from other influences, appears unlikely. While it is difficult to assess the strength of the offsetting and equilibrating forces connected with the multiplier process—which vary from country to country and within a given country at different periods of time—there do not appear to be forces inherent in the particular circumstance that are adequate by themselves to bring a complete equilibrium. Moreover, the forces do not appear to be of the kind which seek equilibrium between exports and imports and which come to rest only when such a position of equilibrium is attained.

Equilibrating adjustments necessitated by monetary injections appear therefore to require changes in prices, in exchange rates, or in other items in order that a balanced position may be achieved. The maladjustments that are created by the monetary injections will, of course, produce pressures for the necessary changes in prices and exchange rates, so that in an over-all sense the equilibrating adjustments tend to take place automatically—insofar as government regulations permit the forces to operate—an important qualification.

Chapter 10

COMPARATIVE ADVANTAGE AND GAINS FROM TRADE

One of the tasks of international trade theory is to explain why trade takes place between countries, why certain goods are imported while others are produced at home. We want to know what determines the articles which enter into international trade and those which are confined to domestic trade. Why does the United States import British cutlery but not many British typewriters? Why does the United States export cotton and import raw wool?

International trade theory also endeavors to explain why the terms of trade, or the ratios at which goods exchange, are what they are. Why does a bale of cotton trade for just so much coffee, or so many yards of silk? Why are ten boxes of Japanese toys the equivalent of twelve American automobile tires or fifty yards of Belgian linen? What determines the total amount of goods and services which a nation must give in exchange for its imports? What determines whether a country gets much or little in exchange for what it exports, and just how much or how little? These two questions were of special concern to the classical economists of the previous century. They are discussed in the present and the two subsequent chapters.

National Specialization in Production.—In order to obtain articles by trade, nations must give something in exchange; consequently they produce more of certain articles than they can themselves consume, and trade the "surplus" with foreigners. A farmer who has good wheat land grows large quantities of wheat and sells the wheat in order to procure clothing, gasoline, etc. Similarly in foreign trade, nations pro-

duce large quantities of those goods for which they are specially suited, and exchange them for other goods. Nations, and also different parts of the same nation, vary greatly in their adaptation for certain types of production. Areas differ especially as follows:

Climate and Natural Resources. Some parts of the world are endowed with coal and iron while others have petroleum, gold, or copper; others have few minerals but possess fertile soils or extensive forests. Some products require a cold climate while others require a hot one. Rainfall and other climatic conditions vary widely and help to determine what an area produces. This is particularly true with respect to agricultural production, but it also affects other types of production. Natural resources and physical conditions play an important part in determining the nature of a country's production.

Labor Supply. The amount and character of available labor are major factors in determining wage costs and the types of articles produced. In the Orient labor is relatively abundant and cheap, while in the United States labor is scarce in comparison with other factors. Oriental labor, however, is largely unskilled. Factors in the labor situation are the existence and strength of trade unions and their effects upon wage rates. Important also are such things as the native abilities of the people, their industry, training, education, and attitudes; also the economic level of the population and the standard of living. In some parts of the world skill in certain occupations is passed on from generation to generation so that the area comes to possess special advantages relative to other areas. Thus, Switzerland makes watches and Norway specializes in fishing.

Capital Equipment. Modern production requires the use of a great many machines and tools. Very little production, even of the most simple nature, takes place today without the use of some tools or equipment. The more extensive and efficient is this capital equipment, the greater is the output for a given amount of effort. Cultivating the soil with crude utensils does not yield the output produced by the use of tractors and modern farm machinery.

Countries differ greatly in the amount of their capital equipment. Advanced nations like the United States and Great Britain have a vast amount of such equipment, while certain of the so-called underdeveloped areas have relatively little. Unlike climate or resources, the origin of this equipment is not in the physical features of a country but is found largely in the utilization of a portion of the country's production for the creation of such equipment, rather than its use for immediate consumption. Nations with a large output of commodities and high standard of living find it easier to save and divert a substantial portion of their productive effort to equipment for further production than do poorer nations with relatively small productive output. Nations with little capital, however, often obtain certain amounts by borrowing or attracting investments from other countries. Regardless of the way in which it came into being, the extent of capital equipment—factories, machines, highways, furnaces, power plants, and the like—varies widely from country to country, and is a major factor in determining the nature and volume of a nation's production.

Nature of Government and Institutions. Some parts of the world, endowed with good resources and productive conditions, are unable to realize their full possibilities of production because of political uncertainties, insecurity, unrest or governmental measures and policies. The nature of the government, laws, and general economic organization have important effects upon a country's production. Governmental inefficiency or inadequacy, lack of freedom and individual opportunity, and uncertain political and economic conditions hamper production, especially that requiring large outlays of capital. Such conditions discourage the accumulation of capital and its investment from other countries.

Proximity to Markets. In terms of transportation costs, the distance or accessibility of an area to markets influences the character of production. Bulky articles are influenced by nearness to markets more than are articles of high value and small bulk, which can afford to bear high transportation charges. Markets nearby, however, are sometimes closed to certain goods

by tariffs and other barriers. Raw materials or other products unless accessible to markets have little economic significance in international trade.

Within a nation production tends to take place in those regions that are best suited for producing the different types of goods. In the United States, for example, iron and steel mills have centered in Pennsylvania and Ohio, chiefly because of proximity to materials and accessibility to markets. Minneapolis is near wheat- and other grain-growing areas and is a logical milling center. Nevada and Arizona contain valuable mineral deposits and therefore are mining states. The different sections of the United States specialize in the production of those articles for which they are particularly well adapted. As a result, production is more efficient and abundant.

As regions specialize, so countries specialize in the production of articles for which they are best suited or least unsuited. Economic forces do not observe political boundaries, unless forced to do so by artificial devices, so that production tends to locate throughout the world, at home or abroad, according as conditions are suitable or unsuitable for the particular goods in question.

National and international specialization are merely extensions of the general division of labor, which has been proceeding from early times. An individual does not grow his own food, make his own clothes, and build his own house. Instead he concentrates on a certain type of work and trades the results of his work for the products of other workers. The division of labor among individuals grows into division of labor among regions and among nations; it is geographic or territorial division of labor. The large industries of the modern world with their dependence upon extensive trade represent a high degree of specialization and division of labor. The specialized nature of production throughout the world, and the advantages accruing therefrom are obvious.

Principle of Comparative Advantage.—The articles which a nation produces at home are ordinarily those in the production of which it either has special advantages or in which it has

the least disadvantages. Furthermore, goods which it imports from abroad are usually those for the production of which it is not particularly well suited. The coffee, bananas, and other tropical products imported into the United States in large quantities are examples. Such articles can be obtained more cheaply from other countries. Borderline cases, however, exist wherein the difference in advantages is not great.

The tendency of countries to concentrate their efforts in the production of articles in which they have special advantages, or in which they have the least disadvantages, is known as the principle of comparative advantage. This means that nations tend to produce those things for which they are best suited, and to avoid the production of those things for which they are the least suited.

The meaning of these expressions, "special advantages," "best suited," "least suited," etc. requires analysis. The reasons why certain goods may be produced more advantageously in some sections than in others, why an area is "well adapted" or "best suited" to a certain type of production, are because the factors of production especially necessary to produce that article exist there in relative abundance. If an article requires much hand labor, countries with a relatively large supply of workers would have an advantage since labor there would be cheap. The factors of production are distributed unevenly throughout the world, which fact results in different productive suitabilities. A particular factor may be relatively abundant in one area but scarce elsewhere as compared to other factors. A small seaport on poor land may devote itself to fishing and be well rewarded, while an inland town may be in a rich agricultural area where land is the abundant factor and agriculture prospers. Labor may be plentiful in one area, but scarce in another as compared to tools, machines, and other items. In some areas capital equipment is relatively abundant so that these areas are suited to industries requiring a large amount of machines and other capital equipment.

In the production of any article the various factors of production, such as natural resources, capital equipment, and the many other items which contribute to production, must be

combined and they may be combined in various proportions. For example, the production of wheat requires land, workers, and tools such as plows and tractors. Numerous combinations of the amounts of each of these factors used are possible. A farm may be cultivated with 100 workers and little equipment, or by ten workers supplied with modern farm machinery. The output might be the same in both instances, or might vary in either direction. If workers are scarce and their wages high, but tools relatively plentiful and cheap, each worker is supplied with more equipment than if a reverse condition prevailed. If workers, on the other hand, are abundant and wages low, the proportion in which workers and capital equipment are profitably combined is different; each worker then has fewer tools. This is the condition in the Orient, the Near East and other parts of the world.

Because the relative amounts in which the factors of production exist vary from one country to another, countries combine them in different proportions. In a country where labor is relatively plentiful and therefore cheap, but capital is scarce, two units of labor might be combined with one unit of capital, whereas in a country where labor is scarce (and therefore dear in relation to capital), one unit of labor might be combined with two or more of capital. The output in each case might be the same, or it might be different. Variations between different parts of the world as to the proportions in which the factors of production exist thus cause some areas to be better suited to the production of certain goods than other areas.

Variations in the relative abundance or scarcity of the factors of production are, it will be noted, the basic reason for the existence of trade. The flow of trade is therefore to be explained largely in terms of the relative scarcity or abundance of the different factors of production. Existence of a comparative advantage with respect to a particular commodity means that the country has an abundance, relative to other countries, of the factor or factors which are most important in the production of that commodity. The expression "factors of production" or "factor equipment" refers not to the narrow classical

division of land, labor, and capital, but includes all agencies, conditions, and facilities which have a part in production.

The United States is in a position to produce almost any commodity it desires if it were willing to pay the price. If necessary, it would be possible to grow bananas, coffee, and other tropical products in the northern states of Maine, Minnesota, and Oregon, by providing hothouses and duplicating climatic conditions of the tropics. The costs, however, would be very high, and only small quantities could be grown, since the factors which are most important in the production of these articles are relatively scarce in the United States. The costs would be greater than most people would be able or willing to pay, so that the great mass of people would have to go without these articles if importation were cut off. These articles can, of course, be obtained more cheaply from tropical countries, where factors necessary for their production exist in favorable proportions; but the United States, nonetheless, could produce them in limited quantities if necessary.

Most of the articles which the United States imports could be produced at home, if this were necessary. In practically every case, however, the costs would be greater than those for which the articles may be obtained from abroad. In some cases the costs would be only slightly higher, while in other cases they would be prohibitive. Certain articles, such as tin and other special metals, exist in small quantities or are lacking almost entirely in this country. Such instances where the article absolutely cannot be produced in the United States in sizable quantities, no matter what the cost, are rare. The United States with its varied resources is in a specially favored position in this respect. The United States could become self-sufficient and could get along without products from abroad with less difficulty than most other countries, but it would suffer severely if this were attempted.

The United States produces practically no natural rubber, silk, tin, coffee, tea, spices, bananas, and certain metals, and produces insufficient amounts for the domestic market of sugar, paper, hides, wool, chemicals, and many other articles. Sugar

is produced within the United States in quantities adequate to supply about one-fourth of this country's requirements. The remainder comes principally from Cuba, Hawaii, and the Philippines. Were it not for this outside supply, and were this country required to produce all the sugar it consumes, the cost of sugar in the United States would be considerably higher, since the domestic production cannot be materially expanded except at greater cost.

The significant fact about this is that the United States and every other nation could produce a greater variety of products than they actually do produce. They could also produce larger quantities of articles the supply of which is now partly imported and partly produced at home. These additional articles and supply, however, could ordinarily not be produced except at higher costs, and probably not without curtailing production in other lines, that is, without drawing labor and capital from existing activities. If American labor produces automobiles, that same labor cannot produce woolens to replace imported woolens, provided, of course, that the economic system is functioning reasonably well so that the labor supply is largely employed. The matter of unemployed labor and idle capital is a separate problem.

Comparative Advantage Not Absolute Advantage.—In the case of a country that clearly has an advantage in the production of a certain commodity, for example, Brazil in the production of coffee (where land suitably situated from the standpoint of climate and other necessary factors are plentiful), the reason for specialization is apparent. But how about the country that is fortunate enough to have rich resources and advantages in many lines, that has an abundant supply of factors that are relatively scarce elsewhere, or, at the other extreme, the unfortunate country that has no special advantages in any line? What determines the kinds of industries which these countries tend to develop? The answer is that each country puts its best foot forward. The fortunate country with many advantages tends to develop only those industries in which its superiority over other countries is the greatest. It does not

bother with those industries which other countries can develop, even though these other countries are not as well adapted in an absolute sense to this production as the first country. The question is one of the relative supply of the factors.

The United States, a country with many natural advantages and an abundant supply of capital equipment, regularly imports certain articles it is as well suited to produce as foreigners. However, the high productivity of American labor and capital in other lines sets standards of returns which the less productive fields in the United States are unable to meet. The most productive fields are thus able to attract the labor and capital. Output is the largest and labor and capital are rewarded best if they are directed toward those industries in which this country is most particularly favored.

A country may be favorably situated with reference to a certain article but may not be able to produce its total supply under favorable conditions, and therefore, may import part of it. The law of diminishing returns, or of increasing costs, often prevents the production of adequate quantities of an article, so that the home supply must be supplemented from abroad. The United States thus produces sugar domestically and also imports sugar. England, though a highly industrialized nation, can nevertheless still grow some wheat to advantage.

The barren country with poor resources and no special advantages endeavors to make the most of what it has, and, therefore, develops those industries in which its disadvantages are the least. It produces those articles which require factors which exist in the greatest relative abundance. These factors may be poor from the standpoint of physical productivity, but are the ones which are relatively the most abundant, or least scarce. The country's efforts may not be well rewarded, but if such a country is to live and import from abroad, it must produce something for export. If it is to secure from abroad those essential commodities which it lacks, it must offer its own goods in exchange. Its own production is the greatest and it has more to trade, and therefore to consume, when it concentrates upon articles in which it has the least disadvantages. It, therefore, may cultivate land that perhaps would be standing idle in more

wealthy countries, and may trade the products of that land for those of the wealthier country. In the wealthy countries, where labor is relatively scarce, labor can be applied more effectively than by cultivating poorer land, even though such land may be superior to that cultivated abroad. This fact explains why arable land may lie unused in America whereas in Europe and particularly in the Orient, land inferior to it is cultivated intensively. In some foreign countries hillsides are terraced and little land is wasted. In the United States such intensive cultivation would be wasteful and uneconomic due to the existence of more profitable outlets for labor and capital.

It will be seen that it is comparative advantage rather than absolute advantage which determines the direction of a country's efforts. Countries in this respect are very much like individuals. An individual, competent in a variety of undertakings, tends to select the occupation in which his ability is the most useful, and where the rewards are the greatest. A person with meager abilities tends to locate in an occupation wherein his deficiencies are the least handicap to him. The occupation may be one requiring only the performing of some simple operation, and the rewards may not be very munificent. The manager of a store or shop may be able to sweep the floors and clean the windows better than the janitor, yet he does not dissipate his energies in this way. His time is better devoted to utilizing his business abilities. A busy executive does not keep his own records or type his own letters, although he may be able to do this better than his clerks. To perform these additional duties would detract from the efficient utilization of his supposedly more special abilities.

Land that is valuable for growing citrus fruits may also be desirable wheat land. Yet it is not used for wheat, since it has special advantages for citrus, and citrus land is scarcer and more valuable than wheat land. Labor and materials expended upon it in the cultivation of citrus are better rewarded in profit to the owner than if they were expended upon this same land in the cultivation of wheat. The citrus fruit produced can be traded (via money) for more wheat than could be grown upon this land with the same effort. Resources thus tend to be uti-

lized for the most profitable purposes, whether the productive advantages (in terms of relative factor equipment) are absolute or comparative.

It follows from the above that countries which are fortunate in having a large amount of valuable resources, are able to obtain good returns for their efforts expended. They thus tend to have larger production, real incomes and higher standards of living than countries with meager resources and few advantages.

The scarcity or abundance of a country's resources, and whether the country is rich or poor, is to be measured in terms of the nature of these resources and their relation to the size of the population. If a country is densely populated its per capita resources may be low; labor, the relatively abundant factor, then finds life harder than in a country of sparse population where labor needs to cultivate only the best soil and mine the ore nearest the surface. The countries where real incomes are the highest are those of good natural resources, not overly populated (labor the scarce factor), whose workers are well supplied with tools and equipment and reasonably well educated, governed by a stable and enlightened government, and where free and democratic political institutions exist. These conditions are conducive to high productivity, and to a high standard of living. Where per capita resources are high—fertile fields, large amounts of timber, minerals, etc.—labor will find its efforts well rewarded and real wages will tend to be high. Where that labor is well supplied with tools and equipment, and has advantages in the form of free institutions, an enlightened government, etc., its rewards are still greater.

Gains from International Trade.—Many benefits come to a country as a result of its trade with foreign nations. In the first place, international trade makes it possible for people to consume many articles which their country lacks and which they would otherwise have to forego entirely. Thus the United States with its diversified resources nevertheless lacks tin, nickel, and various other articles. Most countries lack a great many things.

Trade furthermore permits countries to consume larger quantities of articles which would be very expensive were it not for foreign supplies. A nation may be able to produce a certain amount of an article, but to produce an adequate supply would mean higher and perhaps prohibitive costs. Trade increases the total volume of commodities available for consumption and thereby raises the standard of living. This result is because trading permits goods to be produced by the most favorably situated and most efficient producers, who can produce with the same effort larger quantities than could less favorably situated producers. The labor of a country is most effective and is most bountifully rewarded when it is applied in ways for which the country is best fitted and upon materials with which the country is reasonably well endowed. When energies are utilized in this way the sum total of goods is greater than if the energies were expended in producing articles for which the country was not well suited.

Where competition is allowed to prevail the most efficient producers, wherever they may be, are the ones which tend to do the producing. In the competitive struggle they are the ones which usually win. This tendency for the most efficient to gain the upper hand is strong although in a world of regulations and restrictions, large established industries, monopolistic tendencies, and price and wage rigidities, the most efficient producers may not always win. The principle of the survival of the fittest, wherever in the world they may be located, is nonetheless a strong tendency and is continually at work in the production and sale of commodities. The "fittest" are the ones who in general are the most successful in giving the public what it wants, and in giving this most economically and efficiently.

The increase in total production brought about as a result of production by the most efficient and by the trading of the products (necessary if specialized production is to take place), is one of the benefits which spring from the division of labor and international trade. The division of labor, wherein each person or area specializes according to abilities, cuts across national boundaries, so that production, unless interfered with,

tends to take place in the best location and to be sold in the best market. As a consequence, the volume of production is greater.

The large volume of international trade of modern times represents extensive division of labor and coordination in production. The world has traveled a long distance since primitive man gathered his own food, made his own clothes and provided his own shelter. We are far removed from the time when he first began to work with his fellows in the effort to satisfy his wants, bartering a few simple products. Under the present highly developed system of production and exchange, which embraces the entire world, a worker in one country, performing a simple operation, may be making part of a machine or implement to be used by someone on the opposite side of the globe. That person, in turn, may be helping to produce a raw material which will ultimately, after many others have worked upon it, find its way back to the country of the original worker. All this represents a high degree of division of labor and coordination in production, uniting the entire world into one economic organization.

The large amount of international trade, it will be seen, means greater economy in the utilization of the world's resources and man's abilities. It means that the most fertile soils are being utilized, that the most accessible minerals are being mined, and that the world has a greater quantity and variety of goods than if there were no trade between nations.

Attempts to measure the gains from international trade have had a long history and have resulted in refinements in theoretical reasoning but they have not altered materially the basic conclusions regarding the benefits. These benefits are clear and simple and were observed by the early economists. Plato in *The Republic* remarked "All things are produced more plentifully and easily and of a better quality when one man does one thing which is natural to him and does it at the right time, and leaves other things."[1] Adam Smith emphasized the benefits from international trade and therefore urged free trade. The classical economists thought of the gains in terms of extra

[1] See Chapter 13.

quantities of goods produced and savings in resources. Later analysis shifted from the concept of physical quantities to that of utility, reflecting abandonment of the labor theory of value. The classical economists were concerned with the distribution of these gains among the trading countries and gave detailed study with arithmetic examples to determination of the terms of trade.

The more recent approach to a study of the gains from trade is based on value and price analysis including the use of indifference curves and other techniques.[2] These newer techniques, regardless of some of their difficulties,[3] confirm the essential facts of the gains from international trade as observed long ago and which, in any event, are abundantly clear.[4] This subject is discussed further in Chapters 12 and 14.

Trade and Distribution of Income.—It has been noted that trade is to be explained largely in terms of the relative scarcity or abundance of the different factors of production; also that these factors are combined in variable proportions. Moreover, the rewards received by the different factors are related to the scarcity or abundance of such factors, a unit of an abundant factor receiving less than if such factor were scarce. In a country where a certain factor exists in abundance and is therefore relatively cheap larger quantities of this factor are combined with other factors than if the factor were scarce and expensive.

[2] Indifference curves assume that an individual so plans his outlays for any single commodity that he is on the margin of indifference between the last increment of the commodity bought and alternative increments of all other commodities which might be bought instead. By combining indifference curves with production substitution curves, which indicate the possible combination of quantities of two commodities which can be produced with given quantities of the factors of production, the gains that are derived from international trade can be indicated.

[3] These difficulties include the assumption of a fixed quantity of factors of production and questions about the appropriateness of indifference curves applied to a country as a whole wherein the distribution of income among individuals is altered by international trade.

[4] The fact that trade permits to each country an increase in the quantity of every commodity produced and a decrease in the quantity of work performed was set forth by Paul A. Samuelson, "The Gains from International Trade," *Canadian Journal of Economics and Political Science*, V, 195-205.

If workers are relatively plentiful and wages therefore low, more workers are utilized as compared to machinery than if wages were high.

International trade expands the markets for a country's production, namely for those goods and services in which the country has a comparative advantage, and thereby affects within such country the rewards to those factors utilized in the production of its exports. The goods and services in which a country has a comparative advantage, and which are therefore exported, are those which require the factors which exist there in relative abundance and which are cheap. If a country has an abundance of a certain factor, the goods and services which must utilize this particular factor in large proportions are thus the ones which the country tends to export. The relative returns to the abundant factor or factors are less per unit than elsewhere, as indicated by the fact that if the returns, relative to those received by other factors, were higher than elsewhere, and the costs and prices of the product thereby higher, the country would not have a comparative advantage with respect to such products nor be able to sell them abroad. It is because these factors are relatively cheap, and the returns to them relatively less than in other countries, that articles in the production of which they are important are exported and sold on the world market.

Inasmuch as international trade expands the outlets for goods and services that utilize a country's factors which are abundant and cheap, trade tends to expand the demand for these factors and thereby to increase their prices or rewards. An increase in demand for their products causes abundant factors to be relatively less abundant. Furthermore, the import from abroad of goods requiring for their production factors which are scarce in the importing country relieves pressure on these scarce factors, and accordingly tends to cause these scarce factors to be relatively less scarce and to reduce their rewards. International trade thus tends to equalize the relative returns to the different factors of production throughout the world.

International trade also tends to equalize the absolute returns to the different factors throughout the world. In the case of

factors of equal quality in different countries, a leveling of relative returns, induced by international trade, must necessarily be accompanied by a leveling of absolute returns. A leveling of relative returns or factor prices would mean that the factors would be combined in similar proportions. Similar units of labor are equally productive wherever located if they are combined with other factors of equal quality and according to the same techniques. However, the amounts in which the factors exist throughout the world do not permit combining them in exactly the same proportions in different countries even though trade tends to raise the price of abundant factors and to reduce that of scarce factors. For example if in a certain country factor *A* exists in abundance and receives low returns, international trade will tend to cause articles requiring this factor to be produced there, and the returns to *A* will increase. If, however, factor *B*, which is also necessary for the production of this article, is quite scarce in this country or perhaps does not exist there at all a limit exists to the equalization process. Factors can be substituted one for the other to a certain extent (more tools per worker if wages rise, etc.), and while the rewards and proportions in which they are combined are altered by trade, a complete equalization of relative returns as a result of trade is not conceivable.

If the factors of production were perfectly mobile and moved promptly from country to country, always seeking the highest rewards, such movement would tend to equalize both the relative and absolute returns to the different factors. Most factors, however, are quite immobile. Natural resources must be utilized where they exist. Workers are reluctant to move to a new and uncertain environment, especially to a land of strange customs, and are also often barred by immigration and other restrictions. Capital equipment is potentially mobile but its owners are cautious and prefer to utilize it at home unless the rewards abroad are sufficiently attractive to offset possible risks. Even though the factors of production are often immobile international trade nevertheless has a tendency to equalize both the relative and absolute returns to the factors, but as noted above, complete equalization is not attainable.

It is to be noted that resources, or the supply of a factor in a particular country, are not to be regarded as rigidly fixed, but on the contrary change according to circumstances. For example the land supply is increased by drainage, irrigation, or filling and decreased by erosion or exhaustion. The labor supply fluctuates seasonally and with desires of women and others to seek employment. A change in rewards, or in the relative prices of the factors, may alter the effective supply, which would accordingly have secondary effects upon rewards.

As a result of the effect of international trade upon the distribution of income among the different factors within a country, tending to increase the relative returns to abundant factors and to reduce the relative returns to scarce factors, governmental measures which alter the flow of trade (exchange restrictions, tariffs, quantitative restrictions, etc.) affect the returns to the different factors, particularly the returns to factors that are important in the production of the goods and services immediately affected by the restrictive measures. Thus in the case of a country that exports agricultural products, a tariff on the importation of manufactured goods might expand local manufacturing and tend to increase wages of workers in these industries. The export of agricultural products, however, would be discouraged since if such country reduces imports it deprives foreigners of purchasing power over its own exports, with the result that workers in the agricultural industries would tend to receive smaller returns. The reduced return to agriculture, however, might be felt more by the owners of the land than by the workers. Moreover, since labor costs are often a smaller percentage of the value of agricultural products than of manufactured products, the expansion of manufacturing might result in an increase in the total demand for workers relative to that for other factors, and therefore result in an increase in the total share of the product received by labor. The proportions in which the factors are combined would be altered in favor of the workers. A shift of workers from agriculture to manufacturing might alter the wages of particular groups of workers (tending to reduce or limit the rise of wages of workers in manufacturing and to raise or limit the decline of those in agriculture, or

to raise the latter more than the former), but the increased share to all workers resulting from the tariff would not be reduced by mobility of workers and such a shift.

The extent to which the situation described above would be likely to prevail would depend largely upon both the relative volume of production and the elasticities of demand and supply of such a country's agricultural products that are exported, and also of its manufactured articles the domestic production of which is encouraged. A restriction of manufactured imports, especially if the demand is elastic and the volume imported relatively large, might cause a substantial reduction of foreign trade and be seriously harmful to agricultural production and to the country, particularly if the domestic manufacturing industry aided is not well suited to the country and does not greatly expand, whereas agriculture is suited to the country. The terms of trade, as discussed in Chapter 12, might move against such a country. Total production would in any case be less and the possible gain to the workers would be more than offset by losses to other factors within the country. The decline in productive activity might reduce incomes and cause damage to an extent not compensated by the possible increases in workers' incomes. Such restrictive measures in any event are of a nationalistic nature, and whatever gains they might bring to the country as a whole from possibly improved terms of trade, as noted later, are subtracted from the benefits of trade to other countries.

Chapter 11

PRICES AND INTERNATIONAL TRADE THEORY

Differences in Price Structures.—The theories which explain international trade are fundamentally the same as those which explain domestic trade. The reasons that California produces oranges and trades them for Detroit's automobiles or for New England's shoes are essentially the same as those which cause Canada to produce lumber or India jute, and to trade them for English cutlery or Australian wool. As one part of a nation finds that certain goods can be bought more cheaply in other communities, so nations find that certain goods can be purchased more cheaply abroad than at home.

The price of an article is ordinarily the immediate test of whether the article is imported from another nation (or region of the same country), or produced locally. If a foreign good can be imported and offered for sale more cheaply than a similar domestic good, the foreign good will ordinarily be imported. Because of government regulations and controls, however, prices by themselves are not the sole test of whether a good is imported or exported. Furthermore, prices are often not the result of free and competitively functioning forces. Nevertheless price differences are in general the basic incentives to trade. The many regulations and barriers to the movement of goods that have been piled one upon the other in recent years have not repealed economic laws, nor do they obviate the need for theoretical analysis. The world operates largely on a basis wherein monetary prices play a major role. Price analysis is fundamental to an understanding of international economic relations.

Particularly in recent years have influences other than prices entered into the determination of the direction and nature of trade. Competition and other economic forces are not free to

work themselves out unrestrictedly, so that much economic theory refers to tendencies which are often held in check or dammed up completely by public or private actions. The underlying tendencies, however, cannot be destroyed even though they may be restrained. To understand the real world of international trade it is necessary first to understand these basic forces, regardless of the extent to which they may be controlled by government or seem to be inoperative.

Prices of articles, whether at home or abroad, are expressions of the value relationship of the articles to each other, so that if a pound of sugar sells for ten cents and a loaf of bread for five cents, one pound of sugar is the value equivalent of two loaves of bread. If in another country a pound of sugar sells for two francs whereas three loaves of bread also sell for two francs, one pound of sugar is there the value equivalent of three loaves of bread.

If two countries had identical price structures (identical value relationships of goods to each other), there would not be a single article wherein trade would yield a gain to either party. Any article given would be no more valuable in the country to which it was sent than in the country whence it came. The country where one pound of sugar was worth two loaves of bread, could, however, profitably trade sugar for the three loaves of bread which were the equivalent of one pound of sugar in the second country. Or, the second country, where sugar was more valuable in terms of bread (priced at three loaves), might profitably trade two of its loaves of bread for one pound of sugar from the first country. If the price relationship between these two articles were the same in both countries, however, there would be no basis for trade. Thus it is the difference in price relationships, or the structure of prices, that makes trade possible and provides an incentive to trade. The actual terms of trade—the number of loaves of bread per pound of sugar—is discussed in the next chapter.

The problem of why international trade exists is essentially one of explaining why a certain article has a different value relationship to other articles in some countries than in other countries, that is, why a pound of sugar is the value equivalent in

some countries, not of one loaf of bread but of two or perhaps three loaves of bread. We want to know why the prices of certain foreign articles are cheaper than similar domestic articles, allowing for foreign exchange rates, transportation, and other costs.

Prices and General Equilibrium.[1]—As noted in the previous chapter, nations differ greatly in their adaptation for the production of certain goods. In some nations fertile land is plentiful whereas in others such land is relatively scarce but labor is plentiful. A country wherein land is plentiful compared to other factors of production, would probably find that it had an advantage in producing goods such as agricultural products requiring a large amount of land. Such types of goods, which presumably could be produced easily and in abundance, would tend to have a low value in their relationship to other commodities which were more difficult of production, as compared to the situation in another country where land was relatively scarce.

The value relationship of goods to each other (their relative prices) reflects, among other things, the ease or difficulty with which the different goods can be produced. Goods that can be produced easily, because the necessary factors are abundant, tend to be plentiful and therefore cheap, and vice versa. The adaptation of a country to a certain type of production—that is, whether a good can be produced easily or not—results largely from the relative abundance or scarcity of the factors necessary to its production, as already discussed. If a country has extensive forests, for example, lumber can be produced cheaply and the country is well suited to lumbering. The abundance or scarcity of certain factors of production thus helps to determine whether certain goods are abundant or scarce, and therefore cheap or dear. The structure of prices is to a large degree conditioned by the nature and extent of a country's factors of production.

The value relationship of goods to each other, however, is also a reflection of demand for the different articles—whether

[1] This subject is discussed further in Chapter 15, "Contemporary International Trade Theory."

much or little of an article is wanted and how strongly it is wanted, particularly as compared to other articles which might be acquired instead. An article, or a factor, is abundant or scarce only in relation to the desires for it. An article may appear abundant, yet if the desires for it increase, or if the supply of other articles increases, it becomes relatively scarce even though the absolute amount may not have changed at all. More will be said of this below. To be noted here, however, is the fact that nations or parts of a nation differ in their facilities for producing certain goods. These differences in factor supply are to a large extent responsible for the differences from country to country in the value relationship of goods one to the other.

The comparison, it is to be observed, is not between the ease with which article A, for example, can be produced in one country (because of abundance of necessary factors) as compared to the ease of its production in another country, but between the ease of production of article A as compared to that of article B in the same country, and the situation with reference to the relationship of the same two articles in another country. The ease of production of a certain article is an important consideration in the determination of the size of the supply which is put on the market; and the size of the supply is in turn an important consideration in the price, or in other words, in the value relationship of the article to other articles.

It has sometimes been said that the costs of producing an article determine the price, and that if the costs are high the price is high, whereas if the costs are low the price is low. The costs are determined, it is argued, by the scarcity or abundance of the different factors of production, so that if a certain factor is scarce and dear in price, goods which require it for production have a high cost, and therefore high price. If a certain factor of production, on the other hand, is abundant and cheap, goods which require it have a low cost, and therefore a low price. From this it is reasoned that the costs of production in a country determine what it exports, or to go back further, that it is the scarcity or abundance of factors which determines what it exports. It is said that prices rest upon costs, and that costs

are determined by the scarcity or abundance of the factors of production, which determines in the final analysis what is exported.

While the scarcity or abundance of the factors of production have a profound influence upon costs, and costs upon prices, this simple reasoning is incomplete and may be misleading since it ignores the demand side of the equation. The sequence of causation does not run from cost to prices, any more than it runs in the opposite direction—from prices back to costs. It may be said that prices determine costs just as much as that costs determine prices.

Prices are the immediate result of the interaction of demand and supply forces, and tend toward that point where these opposing forces are in balance, that is, where demand and supply are equal. If the supply shrinks, due perhaps to a scarcity of some kind, the price tends to rise and thereby shuts off some of the amount demanded, until the two meet. Prices equilibrate demand and supply, and are often even below the costs at which the supply was produced, a condition not uncommon during depression when demand shrinks. To understand prices it is necessary to analyze both demand and supply forces.

Prices, demand, and supply represent an equilibrium situation wherein all the components are influenced by each other. Real costs, in the sense of the difficulties of producing an article (and which are determined in part by the relative abundance of the necessary factors), help to determine the size of the supply. If conditions are such that costs for a particular article are low as compared to costs for other articles, the supply of the article will tend to be larger than if costs were high. If costs decrease as the amount produced increases, the supply will tend to be larger than if a reverse condition prevailed.

The size of the supply is an important factor in the determination of the selling price, a larger supply tending to bring a lower price, and vice versa. At the same time, selling prices help to determine how high the costs are which can be entailed by producers, and in this manner selling prices influence the size of the supply. A producer must adjust his costs to the prices which prevail in the market, and unless he can produce at costs

below the prices necessary to sell the goods he cannot continu to produce. Furthermore, by putting his supply on the marke a producer thereby affects the selling prices, an increased suppl) tending to reduce the price. The supply and prices are thu: closely interrelated and each affects the other. Selling price; influence costs and the supply, just as much as costs and the supply influence selling prices. The size of the supply is essentially a result of how much of the article is desired by consumers in the light of the ease or difficulties of producing it, or in other words, its costs, as well as the costs and possible consumption of other commodities.

Demand, based on the desires of the consumers for the article, refers to how much of an article is wanted and at what price or cost. If desires change and more of an article is wanted at the same price, or at a higher price (an increase in demand, i.e., shift of the curve to the right), additional buying takes place and the price may rise. Producers may then be justified in entailing higher costs to meet this demand. Costs thus tend to adjust to demand. The amount that is demanded is influenced by the price, and if a larger supply is not easily forthcoming and, as a consequence, the price rises considerably, the amount demanded may shrink. The price thus influences the amount demanded, and the amount demanded, in turn, influences the price. The extent to which the amounts supplied or demanded are influenced by price is referred to as their price elasticities.

The price of an article is influenced not only by demand for the particular article, but by demand for an almost unlimited list of other goods and services which could be consumed instead. An individual consumer tends to arrange his expenditures so that in deciding the amount he spends for any particular article he is at the margin of indifference as between a further increment of that article and an increment of other articles. The amount of any particular article demanded thus depends not only upon its own price, but upon the prices of everything else, and in all countries. The price of a particular article, similarly, depends not only upon the amount of it demanded, but upon the amount demanded of everything else, and in all countries.

Prices, demand, and supply tend to seek a general equilibrium adjustment.

Since trade is giving something in exchange for something else, the supply of one article is demand for another article, and vice versa. Demand and supply in this sense are identical terms and interchangeable. In a barter economy this is clear. In a monetary economy, however, we ordinarily think of supply as the offering of goods whereas demand is the offering of money, which is a claim on goods. Inasmuch as the two concepts are basically alike, the reasoning that applies to the determination of supply applies also to that of demand. A supply of goods is produced as a means of obtaining, via trade, other goods, and is thus demand for such other goods. The introduction of money complicates matters since money may easily be held more or less indefinitely rather than be spent, and demand may, therefore, be temporarily withdrawn or fluctuate erratically. This condition, namely the irregularity in the rate of spending of money and also in the purposes for which it is spent, together with expansion and contraction in the amount of money, gives rise to changes in incomes, output, prices, and trade. This subject is discussed further in Chapter 9, "National Income and the Foreign Trade Multiplier."

A complete analysis of the theory of demand, of production, and of general equilibrium, particularly in the modern world removed from the nineteenth century laissez-faire economy assumed by earlier economic theory, would take us far afield. It is to be noted, however, that prices are determined by a great many influences which act and react upon each other and which are interdependent. A price is the result of the pull of many forces which tend toward an equilibrium relationship wherein the forces are at the same time cause and also effect.

Prices and Factor Supply.—The structure of prices, i.e., the value relationship of the different commodities to each other, is not the same in any two countries. This situation is caused by inherent differences in the various countries with respect to climate, resources, machines, labor supply, and such matters (summed up in the phrase factor supply), as discussed above,

which determine the ease or difficulty of producing certain commodities, together with differences in demand, including different habits, customs, needs, institutions, and propensities to consume and save. Thus one pound of sugar is worth two loaves of bread here, but three loaves there. It is this difference in price relationship of goods to each other that makes trade profitable.

It has been said that this difference in price relationship or in price structures is not to be explained solely by differences in costs or by differences in factor equipment. It rests upon many differences and a variety of conditions all of which influence each other and which are tied together in a comprehensive general equilibrium. Differences in factor supply are, however, responsible to an important degree for differences in price structures, and therefore for trade.

The abundance or scarcity of factors must be expressed in terms of value to have meaning. If a factor is relatively abundant it tends to be cheap, so that goods which require a large amount of it for production also tend to be cheap. Cheapness and dearness are relative terms, and a factor is cheap or dear depending upon its relation to other factors. A factor automatically becomes cheaper if other factors become dearer. Cheapness is a matter of proportionality between the factors, and the scarce factor tends to be the dear factor and the abundant factor the cheap factor. Scarcity and abundance have meaning only in terms of demand, and if a factor formerly scarce is no longer wanted it becomes abundant. Moreover, a factor is cheap or dear in its relation to other factors in a certain country or region as compared to its relation to these same factors in other countries or regions.

It was said in the previous chapter that countries tend to export those goods in the production of which they have a special advantage, and now it is said that differences in the structure of prices cause certain goods to be exported. These two statements, it will be noted, come to the same thing. Goods which are low in price are ones in which a country has an advantage. The structure of prices varies from country to country largely because advantages or the facilities for production vary. If a

country has an abundant amount of land and therefore an advantage in producing goods requiring a large amount of land, such goods will tend to be cheap. Abundance or scarcity of a factor of production is an important influence determining relative advantages and, therefore, the prices of articles in the production of which this factor is important. Those articles requiring factors which are abundant will consequently tend to be exported,[2] unless some reason prevents.

Factors are themselves articles with prices, and their prices are part of the price structure. The price of a factor is like the price of anything else, the result of a general equilibrium adjustment. If we endeavor to explain the price of an article in terms of its factor costs, that is, in terms of the prices of the factors of production which enter into it, we are thus explaining prices in terms of themselves. The summation of factor costs does not provide an adequate explanation of prices.

The cheapness or dearness of the factors, their prices, help to determine in what proportions they are most economically combined in production. If the price of labor is cheap compared to that of machines, it is more economical to use more labor and fewer machines in producing a given article than if a reverse condition existed. While the price of a factor helps to determine the proportion in which it is combined with other factors, the proportion in turn helps to determine the price. This fact is because the price of a factor is influenced by the demand for it, and the demand reflects the proportion in which the factors are advantageously combined, changes in the proportion ordinarily resulting in changes in demand. The proportion helps to determine the demand and therefore the price, and conversely, the price helps to determine the proportion, an equilibrium relationship.

Technological changes in production may alter the demand for any factor and therefore the price and the most economical

[2] Not all articles produced by an abundant factor are always relatively cheap. The cheapness of a factor may permit its use for articles ordinarily produced by other factors, so that the articles may not necessarily be cheap enough to export. In parts of Central America, for example, mahogany is so cheap that it has been used for railway ties, yet mahogany railway ties were not exported.

proportion in which the factors are combined. Technological changes, by altering factor relationships and the most economical proportion, may favor one country over another and alter a country's comparative advantages, depending upon which factors a country has in abundance.

The cheapness or dearness of the factors of production plays an important part, it will be seen, in the determination of the structure of commodity prices, although this is only part of an equilibrium condition. To the extent that factor cheapness or dearness helps to determine which prices are high and which are low, it helps to determine whether or not a country has an advantage with respect to a particular commodity, an advantage ordinarily existing when a commodity can be produced and offered at a low price.

The value relationship of the factors is therefore a major influence in the determination of the types of articles which can be produced cheaply, and in the production of which a nation has an advantage. Articles requiring a large proportion of factors which are abundant and cheap are ordinarily ones which a country exports, whereas articles requiring a large proportion of factors which are scarce and dear, are ordinarily the ones which a country imports. To consider factor cheapness and dearness as a complete explanation of what a country exports would, however, be to slip into the fallacy of regarding costs as a complete explanation of prices.

The immediate consideration as to whether an article is imported or exported is ordinarily its price, regardless of factor costs. While differences in the structure of prices from country to country indicate what is exported and what is imported, this is not a full explanation, since we must know why these price differences exist. The reasons why prices vary from country to country and why an article may be cheap here or dear there, involve the entire pricing process.

It is sometimes said that if the factors of production existed in two countries in identical ratios (from the standpoint of value), no trade would be profitable, even though one country was rich and well endowed with productive facilities, while the other was poor. While such conditions would tend strongly to

make trade unprofitable, the reasoning puts the emphasis on cost differences rather than on price differences. It neglects demand in the two countries and involves the same fallacies noted above. Since, however, the difference between the price of an article in one country and its price in another country is determined to a large extent by differences in factor equipment, it is correct to say that the principal cause of trade is found in the varying manner in which the factors of production are distributed throughout the world.

Whether the price of an article (or the price of a factor of production) is high or low in comparison to the price of a similar article abroad, can be determined only after the establishment of a rate of exchange. The cost to us of any foreign article varies with the rate of exchange. Yet the rate of exchange itself depends upon how much of the foreign good is being bought, since demand for the article, and therefore for foreign currency with which to pay for it, affects the exchange rate. The rate of exchange is thus itself partly determined by the price of the article abroad, the price determining whether the article is imported or exported and the extent. At the same time, the price abroad is determined in part by the rate of exchange. Importation of the article creates a demand for bills on the country whence it came, and thus influences the rate of exchange on that country. If the good is imported, the rate of exchange tends to become higher (if the rate is free to move) because of this fact, and the price of the foreign good, therefore, dearer in comparison to that of the domestic good. Conversely, if the good is exported it creates a supply of foreign bills and thus affects exchange rates. Movements in the rate affect the price of the good abroad.

Goods and services exported and imported (including all transactions) must balance in value. The demand and supply of foreign bills, a result of exports, imports, and other foreign transactions, bring about a rate of exchange which equilibrates a country's total foreign payments and receipts. Movements in exchange rates may alter the situation with reference to the cheapness or dearness of foreign goods, and thus may alter the comparative advantages or disadvantages of nations. If ex-

change rates rise, a foreign article may become more expensive and cease to be imported, and vice versa. Exchange movements may stimulate or discourage certain trade, but as this trade as a consequence expands or contracts it in turn alters exchange rates. These movements are part of the adjustments toward a general equilibrium.

International Prices.—The prices of goods that move in international trade have a tendency to be approximately the same in all countries, although certain conditions lead to important differences. These conditions which prevent uniformity of prices are principally transportation costs to the various markets, customs duties and taxes, lack of competition because of agreements or other reasons, and particularly exchange restrictions, tariffs, and other barriers to the free movement of goods which thereby create conditions of scarcity here and abundance there. Goods are in fact far from perfectly mobile and frequently do not or are not allowed to flow quickly to the best market. Price differences, large or small, for similar goods therefore often exist.

Furthermore, conditions of demand are not the same in different markets, and if goods are to sell at all in a certain area their prices may have to be lower there than elsewhere.[3] In domestic as well as foreign trade it is not uncommon for essentially identical goods to carry different prices directed to different classes of buyers, in the same market or in different markets.[4] Nevertheless, there is a strong tendency for goods that can be readily transported to have approximately the same prices all over the world, allowing for the differentials mentioned. Competition of buyers and sellers, where it exists, is the principal mechanism which tends to equalize prices. Wheat thus normally sells for about as much in Chicago as it does in Liverpool. Coffee costs about as much in São Paulo as it does in San Francisco or Paris.

[3] It is to be noted that conditions of demand tend to be of no significance in determining long-run prices for goods of constant costs, although a given condition of demand may raise or lower prices for goods produced at other than constant costs.

[4] See note on dumping on page 200.

No hard and fast line can be drawn between international goods and domestic goods, and a certain article may shift back and forth between the two groups in response to changes in exchange rates, costs, demand, and other factors as discussed elsewhere. Certain goods, however, are ordinarily produced and consumed domestically while others customarily sell on the world market. The prices of goods that are more or less inevitably domestic in nature, such as houses, perishable products, and local services, may vary widely from one area to another, due to differences in the abundance or scarcity of the factors of production as well as to differences in demand and in all the elements that determine a price. The price level of a country is made up of the prices of all types of goods, domestic and international, and variations in the level of prices, including both groups, measured in terms of a common denominator, exist between different countries. Such differences, however, tend to disappear under conditions of competition and free markets. Wage levels, both money and real wage levels, also differ widely from country to country since workers are quite immobile as regards movement across borders, and also often within a country.

In order to measure price and money wage differences between countries it is necessary to express prices and wages in terms of a common denominator such as gold, or in fact any currency unit for which representative exchange quotations are available. Gold has been a useful international measure of values, and the different currencies, whether paper, silver, or gold, can all be expressed in gold terms. For example, the peso of Argentina, the zloty of Poland or the baht of Siam will buy, or can be bought by, an amount of gold definite at any given time. Or any currency unit, such as the pound sterling or the American dollar, can be used in the same manner as a measure of value of other currencies. Measured in this way, the price and wage levels of the different countries can be seen to vary. A given amount of gold or of dollars will buy more in some countries than in others.

It is apparent that comparing wages or price levels in the different nations is not an easy matter, especially in view of

differences in the kinds and qualities of goods compared. To compare the movements of price levels and wages is simpler than to compare the relative heights of the price levels or wages. It is easy to say, for example, that prices in England declined 5 per cent while those in America declined 7 per cent, but it is not easy to know whether all prices in England, particularly those of domestic goods and services, are on the average 10 per cent lower or 3 per cent higher than in America.

Prices and the Flow of Trade.—Whether a nation can produce and sell a particular article abroad, i.e., whether it has a comparative advantage with respect to the article, depends upon its ability to lay down the article abroad at a price as low as that of competing foreign goods. Producers tend to produce goods up to the point where their marginal costs equal the market price. Imports thus come into a country when the market there is not being fully supplied by home producers, that is when home producers cannot meet the market demand at a price low enough to make it unprofitable for foreigners to sell there.

To a foreign buyer deciding between competing similar goods the principal considerations are (*a*) the prices of the goods as quoted by the producer or seller, (*b*) the rate of exchange, which expresses the cost to the buyer in his own currency, (*c*) transportation charges including insurance and related items, and (*d*) customs duties. It is in terms of prices that comparative advantages are registered, and if a nation can continuously offer an article abroad at a price to the buyer in his own money which is as cheap as that of similar goods, foreign or domestic, this is evidence that the exporting nation has a comparative advantage with respect to the article, on the basis of prevailing conditions.

When exchange rates are reasonably stable an importer can quickly compare the cost to him of competing foreign goods by converting the foreign selling prices into his own currency and by making allowances for transportation and other costs. In this calculation, the prices and exchange rates are ordinarily the most important considerations. The competitive position of

a nation with respect to the export of a particular commodity therefore is indicated largely by these two items: namely, the internal price and the rate of exchange. If a certain nation's commodity is cheaper to foreigners than that of some other nation it is probably because either exchange rates on that nation are low, or the price of the article in the country of origin is low.

If exchange rates on a country become depreciated and because of this fact certain of its goods become salable abroad, this depreciation means that a large supply of such a country's currency is being offered on the world market, or that less of it is wanted at the former price, a large supply relative to the demand. The country may be importing heavily so that exporters to it have generous amounts of its currency for sale; it may be seeking to send its capital abroad and offering increased amounts of its currency in exchange for foreign money; it may be experiencing a price inflation so that foreign buyers of its goods reduce their purchases because of the high prices, until a fall in exchange rates offsets the rise of prices; or it may be confronted with political uncertainties or other conditions which alter the demand and supply relationship of bills. Whatever the reason, if the fall in exchange rates is not accompanied by a compensating rise of internal prices, the goods of such a country become cheaper to foreigners. Wherever the exchange rate settles, this rate is an important consideration in determining the costs to foreigners of an exporting country's goods. Exchange rates, in turn, are influenced by the extent to which foreigners buy or do not buy.

A country exports those goods which are low in price there as gauged by the price structures of other countries. Such goods are the ones in which its advantage is the greatest or its disadvantage the least. Comparative advantage is thus not measured in terms of hours of labor, sacrifice, or effort expended, but in terms of price. A nation may be poor with meager resources and inferior equipment so that a certain good is produced with considerable effort, yet if labor is plentiful and wages sufficiently low the good may be produced and offered abroad at low prices. China, for example, where labor is abundant and cheap, has an advantage in the production of things

requiring much hand labor, such as laces and carved wood. Measured in terms of effort expended, the cost of hand lace is high, but in terms of prices abroad the lace is cheap. The test, therefore, of whether a nation has an advantage with respect to a particular article is not the number of days of labor involved, but rather whether the nation can offer the article abroad at a price, including exchange and all other items, which is low enough to compete with the prices of similar goods from other nations.

In both international trade and domestic trade, goods tend to be produced in the cheapest market and sold in the dearest market, after allowing for exchange conversion, costs of transportation, and the like. Goods which can be produced at low costs and offered at low prices, tend to undersell and drive out high-cost goods of equal quality. The competition of low-priced goods with high-priced goods, and the tendency of low-cost producers to gain the upper hand, is the force through which a certain industry is led to expand while another must contract, according as the competition is successful or unsuccessful in satisfying the buying public's demands most economically. It is a force through which production becomes organized along international lines, and determines that this country produce wheat, that country steel, and a third country textiles. It also has an equalizing effect upon selling prices so that the prices in two markets of a commodity that is able to move freely between them tend to differ by an amount not much greater than the costs of transportation. Because of competition to sell, no goods are likely to remain materially higher in one market than in another, apart from transportation, tariff differentials, and certain restrictions which may interfere with their movement.[5]

[5] The practice known as dumping—selling goods abroad cheaper than at home—is an attempt to adapt the price to different buyers, or sometimes an attempt to obtain a foothold in a market. It may also be undertaken for political reasons or to get rid of a domestic surplus, perhaps in connection with a subsidy program. The procedure is similar to the policy of a monopolist in charging different prices to different consumers, especially when it is difficult for them to resell the products to each other. Electric power is often sold at different rates for different types of consumers; railways com-

Trade Theory and the Real World.—When we come to apply the theoretical reasoning of international trade to the real world in which we find ourselves, we discover practical conditions which seem out of harmony with theoretical explanations. Artificial restraints on trade interfere with the free flow of goods to markets. Competition is far from perfect. Production is subsidized. Exchange rates are fixed and the purchase and sale of exchange controlled. Price and wage rigidities, and a wide range of government regulations and private activities alter the situation radically. Much theory is built upon the assumption of a free economy; yet the modern world has moved a considerable distance from the nineteenth century laissez-faire system, based on free enterprise wherein capital was relatively unfettered in its search for profits.

Most nations, moreover, are more interested in maintaining their "way of life" and accomplishing certain domestic objectives than in extending trade. International trade is commonly sacrificed to national ends. Trade also tends to follow accustomed channels and is frequently subject to mere inertia. Imperfect knowledge on the part of producers regarding markets sometimes holds trade to familiar routes, as do risks of new ventures, perhaps due to political uncertainties. No simple formula will describe the actual international productive organization and the pattern of trade.

The development of industries in one place rather than in another, and the flow of trade this way rather than that way, is often due to social, political, institutional, historical, and even accidental factors. These factors have led to the migration of peoples and skill from one country to another country, to edu-

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monly have different rates for different commodities even though the cost of the service may be identical.

Where dumping is carried on under a free economy and at a profit to the producer, cost calculations for that portion of the goods dumped may omit overhead and other fixed charges which must be borne by the producer. The portion of goods sold at home is thus made to bear this burden of overhead. The only costs charged against the goods dumped may be marginal or prime costs—the costs of producing the extra units—as against the average of total costs charged against the goods sold at home.

cation and invention, or to the lack of these, and to the settling of some parts of the world in preference to others.

While much of the world's trade and the distribution of industries seems to be patterned on no basis that can be explained by economic theory, the case for theoretical reasoning is not easily dismissed. Economic forces underlie the entire complicated system and represent powerful tendencies pulling this way or that. They are not nullified by special circumstances any more than the airplane refutes the law of gravitation. Institutional changes do not invalidate theory but may compel further and new analysis, especially from the standpoint of regulatory techniques. This is particularly the case today, and in this analysis theoretical tools must be well supported by consideration of the world as it is.

Chapter 12

TERMS OF TRADE

Quantities and Values of Goods Traded.—We have seen how international trade promotes specialization and efficiency in production, and brings a better utilization of resources and a greater volume of production. We have also considered why a nation exports certain articles and imports certain other articles. The present chapter deals with the terms of trade, that is, the forces which determine how much a nation must export in exchange for what it imports. We want to know what determines the amount of a nation's goods and services which must be given in order to pay for the goods and services which it receives from abroad.

It is, of course, true that the exports of a nation must be equivalent in value to its imports, since in any trade that which is given automatically equals that which is received; but why do exactly so many bushels of wheat, yards of cloth, and tins of food exported together equal in value so many tons of steel, automobiles, and barrels of oil imported? Why no more or no less? The problem is similar to determining, when individuals trade goods, why each is able to obtain just so much and no more.

The value of a country's exports, or imports, may move differently from the physical quantities of the goods involved. Imports or exports, according to value figures, may be increasing, yet the physical quantities of the goods may not be increasing, or if increasing, then not at the same rate as the values. For example, exports from the United States increased from $7,920,000,000 in 1919 to $8,230,000,000 in 1920; yet the quantities actually declined. The price level was rising rapidly during these years, and the quantity of goods exported in 1920 was actually less than in 1919 even though the value of exports

rose. On the import side, the value of imports increased sharply in 1920, but the quantity figures increased only slightly.

In addition to changes in the value of goods due to movements in the value of money are changes in the values of individual goods in relation to the values of other goods. Some goods become more valuable and will command a larger amount of other goods, whereas others become less valuable. Similarly, the goods and services which a country exports may become more valuable or less valuable in terms of the goods and services of other countries.

The terms of trade are concerned with the value of a country's exports in the world market as measured in terms of other countries' goods and services. If a country's exports have an increased value or purchasing power over foreign goods and services, the terms of trade have become more favorable to such a country. It can import more for the same amount of exports, or, if it chooses, can add to its foreign assets and import as before.

Physical quantities of goods do not constitute an accurate measure of values, and a doubling of quantities does not necessarily mean a doubling of values. Nevertheless an increase in quantities received for the same quantity given usually represents an improvement in the terms of trade.[1] If a larger quantity of goods and services having a greater total value are obtained in exchange for goods of the same total value as before, and if more value is thereby received for the same amount of productive service or work performed, it is clear that an improvement has taken place.

To speak of the terms of trade as favoring one country or another is misleading since it is well-nigh impossible to measure precisely the respective gains in view of the many intangibles. A shift in the terms of trade, however, may be observed as favoring one country or another. In any trade both parties

[1] It would not represent an improvement in the event that the larger quantities received had become less valuable in terms of goods in general, perhaps because of a technological improvement which reduced the demand for them. After the invasion of Korea the terms of trade shifted in favor of countries exporting raw materials and against those exporting manufactures.

gain or expect to gain, but trade is frequently of greater importance to one country than to another. If a country obtains by trade a large amount of goods important to it and difficult for it to produce, and gives in exchange goods easy for it to produce, it has received a large gain. To determine which country gains the more and how much more is not easy, although it is often possible to know whether the terms of trade move in favor or against a particular country.

Reciprocal Demand.—The terms of trade of a country are the result of demand and supply forces which were summed up by John Stuart Mill in the phrase "reciprocal demand." Reciprocal demand refers to the demands of countries for each others' goods and services, the demand of each country for the goods and services of all other countries, and to the demand of all other countries for the goods and services of the first country. When we speak of a nation's demand for foreign goods and services, we refer to a general composite of its demands for all commodities imported. The demand of the United States, for example, is the demand of its citizens for foreign rubber, coffee, tin, wool, shipping services, etc. It is possible to conceive of a hypothetical demand schedule for a country consisting of the amounts of all foreign goods and services desired by it from all countries, at various prices, that is at various amounts of its own goods and services offered in exchange.

On the supply side, what a country can offer and sell abroad is the basis of its purchasing power over foreign goods and services, its effective demand. The supply of a commodity is at the same time demand for some other commodity, so that supply and demand are similar concepts viewed from different positions. As in the case of demand it is possible to conceive of a hypothetical supply schedule for a country as a whole, representing amounts of its goods and services offered at a series of prices.

The interplay of these demand and supply forces in the world market establishes the values at which a country's goods and services exchange for foreign goods and services. The larger the amounts of a country's goods and services that are demanded

abroad, the greater is its purchasing power over foreign goods and the more favorable to it are the terms of trade, other things remaining equal. If the world desires large amounts of a country's goods and services, such country receives large amounts of foreign currency which may then be used in purchasing foreign goods. Some countries are especially dependent upon foreign sources for large quantities of goods, whereas other countries have diversified production and are reasonably self-sufficient as regards most goods. If a country produces goods which are strongly desired in large amounts by other countries, and if its own demands for foreign goods and services are relatively small, it can obtain goods in exchange for its exports upon a more favorable basis of trade than if it had difficulty in exporting, and especially if this were coupled with a strong demand by it for foreign goods. If a country produces goods for which other countries do not have a large and insistent demand (if its factors which exist in relative abundance do not lend themselves or are in fact not used for the production of goods which are readily sold abroad), while its demands for foreign goods are large, it will be required to offer generous amounts of its own goods (productive services) in trade in order to obtain its imports.

Reciprocal demand conditions are reflected in the prices of exports and imports and in the prevailing rates of exchange. In a free market the demand and supply equilibrium between exports and imports thus sets the terms of trade. In a controlled economy wherein costs, prices, exchange rates, and the flow of trade are subject to regulation, the terms of trade are altered according to the extent and nature of the controls.

The relative size of a country's foreign trade, i.e., the percentage of its national income, does not by itself indicate whether the terms of trade are favorable or unfavorable. Export and import transactions must be equal, and a large foreign trade may be due to the country's large demand for imports, necessitating large offerings of its own goods and services, or it may be due to a large foreign demand for these goods and services which provide it with large amounts of foreign exchange and encourage imports.

A wide range exists in the size of countries and in the volume and strength of their demands, and also in the nature and extent of their supplies. The supply and demand of a particular country are part of the world supply and demand, and the prices of commodities which a country exports are fixed in the world market. The extent to which a country can sell in this market is determined in part by its demand for foreign goods and services and the need to pay for them, its domestic costs being adjusted to world prices by movements in the exchange rate and by internal adjustments, and in part by its factor supply situation. The relative size and pull of the demands of countries for the goods and services of each other, and the factor supplies of each, are in brief the forces which determine the ratios at which countries exchange goods with each other.

It will be observed that we are dealing with the general theory of demand and supply, of value, distribution, and price, applying the theory to nations in their trade with each other. The principles are essentially the same as prevail in domestic trade, although when applied to nations special conditions are to be noted. In applying the theory of demand to a country as a whole, a factor which influences the general equilibrium and thereby the terms of trade is the fact that the demand schedule for an entire country (or indifference curves for the country if this approach is used) depends in part upon the distribution of incomes as between individuals within the country, an increase or decrease in an individual's income affecting his demand for foreign goods and services. International trade, however, affects this distribution of incomes, and therefore a movement in trade may cause a shift in the community demand with consequent secondary repercussions on the country's trade.

When incomes in a country increase, its demand for foreign goods and services also increases. In the short run this increase in demand may take place with little effect upon prices, exchange rates, or the terms of trade. Eventually, however, if the increase in demand is of sizable proportions the terms of trade are likely to be affected through price or exchange rate movements. A shift in demand for foreign goods and services may thus require new terms of trade to bring equilibrium. This subject is

discussed further in the sections on exchange rates and on balance of payments adjustments.

The equilibrium which results from the interplay of demand and supply forces in nations' trade with each other is affected by the elasticity of (*a*) a country's demand for imports, (*b*) the foreign demand for its exports, (*c*) its supply of exports, and (*d*) foreign countries' supply of exports to it. These elasticities of demand and supply which affect the rate of interchange of products appear generally more important in the short run, making for fluctuations in the terms of trade, than in their long-run influence on such terms. Countries' demands and supplies are also influenced by substitutions of domestic products for imported goods, and of additions to exports of domestic goods formerly not exported accompanying equilibrating adjustments.

The foreign trade of a country is part of a general world equilibrium so that a shift in the terms of trade anywhere may affect several or all nations. As noted above, Brazil may sell coffee to the United States but prefer to buy British goods or those of other countries. If Brazil has fewer American dollars because of a decline in the American demand and a fall in the price of coffee in the United States, she tends to buy less from Great Britain and other countries, which in turn buy less from the United States. The United States, however, gets its coffee cheaper (lower coffee prices) in terms of its exports, than originally. The ramifications, however, may be extensive; for example, United States exports may fall in price in view of the decline in demand for them, and exchange rates may be altered by the shifts in demand. The terms of trade are constantly changing, and thereby favor one nation or another. National policies such as those which have to do with prices, exchange rates, or the flow of commodities alter the terms of trade, and may have extensive consequences as discussed in other sections. Such alteration may lead to an imbalance in a country's international accounts or may narrow the volume of trade.

The terms of trade and how the benefits of trade are shared were discussed about 100 years ago by John Stuart Mill. Mill wrote as follows:

If, therefore, it be asked what country draws to itself the greatest share of the advantage of any trade it carries on, the answer is, the country for whose productions there is in other countries the greatest demand, and a demand the most susceptible of increase from additional cheapness. In so far as the productions of any country possess this property, the country obtains all foreign commodities at less cost. It get its imports cheaper, the less the extent and intensity of its own demand for them. The market is cheapest to those whose demand is small. A country which desires few foreign productions and only a limited quantity of them, while its own commodities are in great request in foreign countries, will obtain its limited imports at extremely small cost, that is, in exchange for the produce of a very small quantity of its labour and capital.

. . . an increase of demand for a country's exports in any foreign country, enables her to obtain more cheaply even those imports which she procures from other quarters. And conversely, an increase of her own demand for any foreign commodity compels her, *caeteris paribus,* to pay dearer for all foreign commodities.

The law which we have now illustrated, may be appropriately named, the Equation of International Demand. It may be concisely stated as follows: The produce of a country exchanges for the produce of other countries, at such values as are required in order that the whole of her exports may exactly pay for the whole of her imports. This law of International Values is but an extension of the more general law of Value, which we called the Equation of Supply and Demand. We have seen that the value of a commodity always so adjusts itself as to bring the demand to the exact level of the supply. But all trade, either between nations or individuals, is an interchange of commodities, in which the things that they respectively have to sell constitute also their means of purchase: the supply brought by the one constitutes his demand for what is brought by the other. So that supply and demand are but another expression for reciprocal demand: and to say that value will adjust itself so as to equalize demand with supply, is in fact to say that it will adjust itself so as to equalize the demand on one side with the demand on the other.[2]

While the above quotation lacks the refinements of current economic analysis, it nevertheless contains the basic principles involved in the determination of the terms of trade.

[2] Mill, *Principles of Political Economy,* II, Ch. 18.

Exchange Rates, Prices, and the Terms of Trade.—The rates of exchange between a country's currency and foreign currencies, in conjunction with prevailing prices of exports and imports, establish the terms of trade for such country's foreign transactions, as noted in the previous section. Changes in such prices or changes in the rates of exchange alter these terms. If we assume given prices and a floating rate of exchange, the rate of exchange establishes the immediate terms of trade, whereas if we assume a fixed rate of exchange but uncontrolled prices, prices establish the immediate terms of trade. Prices and exchange rates both reflect demand and supply conditions, although exchange rates are commonly fixed and move less frequently than prices.

The situation may be illustrated by the case of Venezuela. Venezuela exports large amounts of petroleum which are sold abroad at world prices. The Venezuelan supply, like that of other large petroleum producers, influences to some extent the world price. Venezuela receives large amounts of foreign exchange from her exports and is thereby able to maintain a rate of exchange with the United States and other countries favorable to Venezuela in the sense that it causes imported goods to be cheaper than would be the case without the petroleum exports. Within Venezuela prices in terms of United States dollars are relatively high compared to most other Latin-American countries. High dollar costs within Venezuela militate against exports of commodities other than petroleum, with the result that these other exports account for only about five per cent of total exports, even though they have been aided by indirect subsidy. The terms of trade, which are relatively favorable to Venezuela because of the large petroleum exports, are established by the world prices of Venezuela's exports and imports, and the rate of exchange. Such an explanation to be complete, would, of course, require further analysis of the forces which determine these prices and the rate of exchange.

If the prevailing exchange rate of a country does not bring equilibrium on the basis of existing prices and the volume of transactions at these prices, and a rate adjustment is necessary to bring equilibrium, the new rate, which presumably is an

equilibrium rate, alters the relationship between the prices of the goods and services of such a country (unless these move to compensate) and those of foreign countries. Such rate adjustment therefore may alter the terms of trade. The extent and nature of this possible alteration largely depend immediately upon the elasticities of demand and supply. The terms of trade may be affected considerably by a rate change or they may be affected very slightly or not at all. Inasmuch as the previous rate was presumably not an equilibrium rate the effect of the new rate, which presumably is an equilibrium rate, is in the direction of restoring or establishing terms of trade that are based on underlying demand and supply conditions and the distribution of the factors of production. The adjustments in production, in costs and in demand which take place in response to the new rate, may require considerable time to work themselves out so that the immediate effect on the terms of trade may not be the ultimate result. Before the ultimate result can be achieved, however, it is probable that new forces will have intervened.

It is not to be assumed that a change in the exchange rate leaves prices unaffected. The raising or lowering of the foreign exchange value of a currency, by making the goods and services of such country immediately more or less expensive to foreign buyers, and by making foreign goods and services immediately more or less expensive to it, may alter the volume of such country's exports and imports and accordingly may affect their prices. The extent of such price alteration depends upon the elasticities referred to and the proportion that such country's exports and imports are of world trade in the particular goods and services involved. For example, if the commodities imported by a country are, in the case of each commodity, a small proportion of world trade in such commodity, a change in the rate of exchange (and therefore in the amount of such commodity imported), will have little effect upon the world price of the commodity. On the other hand if the country is a principal purchaser of a certain commodity, a higher imported cost of this commodity (because of a depreciation in the exchange rate) and an elastic demand may result in a curtailment of

imports and a lower price abroad for the commodity. The elasticity of supply would also be a factor.

Favorable terms of trade and high prices, as measured in terms of an international unit, tend to accompany each other; and conversely, unfavorable terms of trade and low prices, relative to those in foreign countries, tend to accompany each other. Under the gold standard if foreign countries desired relatively large amounts of a country's goods and services, whereas such country's own demands from them were small thereby resulting in favorable terms of trade for it, such a country would tend to receive gold and to have higher prices, wages, and monetary incomes than if the reverse situation prevailed. The countries losing gold would at the same time tend to have lower prices, wages and monetary incomes.

In the absence of the gold standard exchange rate adjustments, to the extent that they are in the direction of an equilibrium rate, tend to accomplish the same result, namely raising prices in terms of foreign currencies in response to favorable terms of trade, and vice versa. Favorable terms of trade and a relatively high level of prices and incomes thus tend to go together and vice versa. The relatively higher monetary wages and incomes of a country with favorable terms of trade are beneficial to such a country when spent on foreign goods and services. They do not, however, necessarily indicate high real incomes with respect to domestic goods and services.

By maintaining an exchange rate above (a low value for foreign currencies) the equilibrium level, and thereby making foreign goods and services cheaper, it is possible that under certain conditions a country may gain for itself an advantage, at least temporarily, with respect to the terms of trade, although total trade may be narrowed. If a country maintains an artificially high rate of exchange its goods and services are more expensive to foreigners than would be the case at a lower rate. If a large and inelastic foreign demand for its goods and services exists, their export at the higher rate may yield a larger amount of foreign exchange than at a lower rate. The large amount may be in an absolute sense or larger in relation to the volume of exports. The situation is similar to

that in the case of a monopolist who raises the selling price and because of an inelastic demand is able to realize larger total gains, although the volume of sales may be less. The higher exchange rate also makes imports cheaper, and may thus yield more favorable terms of trade than would an equilibrium rate. Unless the demand for imports is inelastic, however, the lower rate may lead to enlarged imports and a deficit in the balance of payments. Even though the terms of trade may be more favorable, the total volume of trade may be reduced, with unfortunate repercussions on the country's level of employment and economy in general, as well as on conditions in other countries.

In the case of a country that maintains a high exchange rate in the attempt to improve the terms of trade, the gain, if any, may be short-lived. Foreign buyers may turn to new sources of supply or to substitute articles. Exporters in such a country may lower their prices in competing for export markets, in which case the benefits of the high price of foreign currencies would tend to disappear. To the extent that a net gain in the terms of trade for such a country continues it is in any event acquired at the expense of other countries and is not a net gain from the standpoint of world production and trade.

Countries with fixed exchange rates have at times depreciated their rates in order to gain a trade advantage for their exporters. A lower exchange rate causes the country's goods to be cheaper abroad and thereby promotes exports. It tends, however, to worsen the terms of trade, at least temporarily, and such a country finds itself giving relatively more goods and services for the same monetary value, the extent depending upon elasticities. The trading advantage, moreover, continues only so long as internal costs and prices do not rise and offset the cheapness to foreigners resulting from the lower exchange rates.

When exchange depreciation takes place it commonly occurs after internal costs have risen and is merely a necessary adjustment to bring rates into line with the higher internal costs, and to promote equilibrium in the balance of payments. It may be undertaken, however, principally to gain a competitive advantage for exporters, rather than for balance of payments reasons. These two situations merge together and are difficult

to distinguish. While much has been written about "competitive exchange depreciation," depreciation of this kind is in fact rare and is confined largely to the practices of Nazi Germany and a few other countries during the prewar period. Depreciation ordinarily takes place because it is needed to aid lagging exports and to discourage excessive imports, and thereby to promote balance of payments equilibrium. At the same time it aids the competitive position of exporters.

An expansion in exports due to exchange depreciation tends to increase the national income and thereby offset to some extent any loss from unfavorable terms of trade due to the shift in exchange rates. The expansion in exports leads to increased money expenditures in the export industries and in the entire economy with a resulting increase in incomes. Such a result, however, is probably only temporary. This subject is discussed in Chapter 9 on "National Income and the Foreign Trade Multiplier."

Output, Terms of Trade, and Standards of Living.—In some nations goods which are exported are produced easily and with little effort. Yet these goods are often traded abroad for goods which require much more effort to produce. For example, the United States normally exports wheat to China and receives in return silk and tea. The wheat represents much less labor to the United States than does the same value in silk and tea to China. Again, India imports manufactured articles from England and sends in return jute and tea. The manufactured articles represent much less effort on the part of England than does the countervalue in jute and tea on the part of India. Hand-made laces and embroideries coming into America from the Philippine Islands do not buy for the Philippines enough American food products and machinery to represent an equivalent amount of toil on the part of Americans. If the rates at which the above goods exchange were altered so that China could get more wheat for her tea, India more manufactured articles for her jute, and the Philippine Islands more food products for the laces and embroideries, the trade would be more nearly equal in terms of effort.

There is, of course, no accurate way of measuring and comparing real labor costs, effort, or sacrifice, although the earlier economists gave a great deal of attention to this problem. It is clear, however, that the quantities of goods traded are at present equal only in terms of value, that is, in monetary value as expressed through prices and exchange rates. They cannot be said to be equal in terms of labor or sacrifice, nor in a physical sense because bushels and pounds and yards do not mix and cannot be compared.

In areas where labor is relatively scarce as compared to other factors of production, the rewards to labor are higher than if labor were a relatively abundant factor. The proportionality in which factors exist varies from country to country, and in countries where the population is large in relation to resources and capital equipment, workers receive lower wages and real incomes than in countries where labor is a relatively short factor. In countries where labor is scarce in relation to capital, real wages and living standards thus tend to be high. The amount of goods given by such a country in trade with countries where labor is relatively abundant represents, in general, less effort and sacrifice than the goods received.

In a country where labor is relatively scarce if the high productivity of workers does not apply to exportable goods or services, the terms of trade of such a country may not benefit by the relatively favorable position of its workers. If the goods which its workers produce easily are essentially domestic goods and not in large demand abroad, its supplies of foreign exchange may be scarce, the rate of exchange high, and imported goods expensive. The standard of living may be relatively high in terms of food, shelter, and other domestic goods, but may not be high in terms of automobiles and other imported goods.

If an increase in efficiency in a particular country applies equally to all goods, and as a result of this equal application the structure of prices remains unchanged (an unreal assumption), there would then be no effect on the terms of trade and no benefit to foreigners, for reasons explained above.[3] High general efficiency would not in itself necessarily affect the structure of

[3] See Chapter 11.

prices, and without affecting the structure of prices, it would not affect foreign trade. In reality, however, an invention or an increase in efficiency does affect the structure of prices and results in a cheapening of certain types of goods in terms of other goods. This cheaper relationship of certain goods spreads to other countries thereby benefiting them. The efficiency of American and European manufacturing industries has made a large supply of manufactured goods available all over the world.

A cheapening of production in a particular country of goods that it exports benefits that country in foreign trade in that the goods which it offers abroad represent to it less productive effort than formerly (or it may have more goods to offer representing the same effort). While a cheapening of production does not necessarily make the terms of trade more favorable or less favorable, depending on elasticities, such a country will probably in the aggregate be producing and trading larger quantities of its goods. The larger production might have to be traded for foreign goods at less favorable ratios, but since the goods offered are produced more easily than before, such a country would still be better off, and would be sharing some of the advantages with other countries.

In the United States the output per worker is high and the supply of commodities is consequently large. Productivity is high because the laborer is well equipped with tools and machinery, has rich, abundant and diversified resources upon which to work—land, timber, minerals, and other resources are plentiful—and because he is in a country where training may be acquired, where production is efficiently organized, and where a stable government and free institutions prevail. Most factors of production are abundant in the United States in relation to labor and are therefore cheap. The United States is not as densely populated as many other countries, which means that resources and physical wealth in the United States are relatively high per capita. Labor, the short factor, is therefore effectively applied and the output per man is large. The high productivity of the American laborer makes it possible for him to have a large real income—a large amount of commodities to consume, and a high standard of living.

In countries where labor is less effectively applied, the output of commodities is less, and real incomes of workers are accordingly lower. If labor were entirely mobile, and were free to move to the countries where production was most efficient and where labor was most generously rewarded, these discrepancies in incomes would tend to disappear, and the standards of living would become more nearly equal throughout the world. Labor, however, is extremely immobile; also, immigration restrictions interfere with movement from country to country. The world is not one of free movement of labor and capital and of perfect competition.

The high productivity of the laborers of some countries as compared to those of other countries accounts for the great bulk of the differences in incomes of the people of some countries in comparison to those of others. This condition also prevails within a country. The efficient persons obtain a larger share of the social product than the inefficient. As between foreign countries, since some countries have a relatively higher level of productive efficiency than others, they are able in their trade with the rest of the world to give, and therefore to receive, a large amount of goods in terms of the expenditures of their effort.

High incomes within a country are the result primarily of two sets of conditions: first, productive effectiveness of a country's workers (adequate resources, capital equipment, etc.), and second, favorable terms of trade. The former is likely to be the more important influence in the level of real incomes. A country like Venezuela that exports large amounts of oil and that can maintain an exchange rate which makes imports cheap has favorable terms of trade which make real incomes higher than they would otherwise be. Favorable terms of trade tend to result in higher prices and monetary incomes, in terms of an international measure of values, as noted in the previous section. These higher monetary incomes represent higher real incomes insofar as the incomes are spent on foreign goods and services.

A high level of monetary incomes (in terms of an international measure of values), which would also represent relatively high real incomes, does not necessarily indicate high costs of

production. If the high incomes are due to productive efficiency of workers costs may in fact be low. In the United States, where incomes are high, prices and costs of most articles, especially manufactured articles, are cheaper than abroad. The large exports of the United States attest to this fact. American goods compete successfully all over the world, in fact from the standpoint of many foreigners, they compete too successfully. To the extent that the effectiveness of American workers applies to domestic goods, these domestic goods are also cheap.

Similarly a country of low wages is not necessarily a country of low costs. Wages may be low because of a large supply of workers who work on poor resources and with inadequate equipment. Low wages may result in low costs for personal services, and items such as locally produced food and shelter wherein labor represents a large part of the cost. Even in such cases, however, higher paid workers in foreign countries equipped with modern tools can often produce these items at lower costs.

The high productivity of the laborers of some countries, while beneficial to these workers, is not detrimental to the laborers of other countries. On the contrary, it is probably helpful to the peoples of all countries. The good fortune of some laborers is not the misfortune of others. Were it not for the high productivity of some countries, the countries with poorly equipped laborers might obtain still less in their international trade. For example, because American farm labor is well supplied with tractors and fertile land, the supply of wheat is increased. Wheat becomes cheaper in terms of other goods not only in America, but in China and in all countries. More wheat tends to be offered by America for the purchase of tea, silk, jute, etc. This may or may not result in a change in the terms of trade, depending on elasticities, but the probabilities are that the terms would shift, at least temporarily, toward more wheat for a given amount of tea, silk, jute, etc. Ultimately, the cheapness of wheat might cause some countries to stop producing wheat and produce other commodities, with corresponding effects upon the ratios of trade between wheat and other commodities.

Chapter 13

HISTORY OF INTERNATIONAL TRADE THEORY—EARLY DOCTRINES

International trade theory as generally accepted today is the result of a long evolutionary process. The theories of international trade have been sifted and debated until today the differences of opinion regarding them are more matters of detail than of fundamental principle. A study of the history and development of international trade theory is helpful in understanding present-day theory and problems. The next three chapters, therefore, are devoted to a brief history of international trade theory.

Ancient Thought.—Many modern ideas on trade, domestic and foreign, can be traced to ancient times. Scattered references to trade appear in the Old Testament,[1] but most of these passages are of interest as indicating merely the existence and extent of trade in this early period rather than as giving Hebrew views on trade.

The fact that trade takes place according to natural advantages was well understood in Greek and Roman times. Literature of that period points out that inherent differences between peoples and kingdoms made trade of mutual benefit. Specialization and trade were recognized as being profitable to both parties, since resources and conditions in the different regions were varied.

Plato (*c.* 428—*c.* 348 B.C.) on several occasions referred to trade. His ideas on commerce do not always appear consistent, but the contradictions are perhaps more apparent than real. He

[1] See Gen. 34:10, 21; Gen. 46:32. An especially interesting passage may be found in Ezek. 27.

did not have a high regard for the business of making money, and declared that "there are in all three things about which every man has an interest; and the interest about money, when rightly regarded, is the third and lowest of them: midway comes the interest of the body; and, first of all, that of the soul." [2] Plato regarded the division of labor and trade as necessary and useful, but did not hold in much esteem the traders of his day. His views on the division of labor are found in *The Republic.* He points out that "we are not all alike; there are diversities of natures among us which are adapted to different occupations." He significantly concludes that "all things are produced more plentifully and easily and of a better quality when one man does one thing which is natural to him and does it at the right time, and leaves other things." [3]

Plato shows that where there is specialization, there must be markets, trade, and merchants. In the dialogue between Socrates and Adeimantus occurs this interesting passage:

". . . to find a place where nothing need be imported is well nigh impossible."

"Impossible."

"Then there must be another class of citizens who will bring the required supply from another city?"

"There must."

"But if the trader goes empty-handed, having nothing which they require who would supply his need, he will come back empty-handed."

"That is certain."

"And therefore what they produce at home must be not only enough for themselves, but such both in quantity and quality as to accommodate those from whom their wants are supplied."

"Very true."

"Then more husbandmen and more artisans will be required?"

"They will."

"Not to mention the importers and exporters, who are called merchants?"

"Yes."

[2] *Laws*, Bk. V (Jowett translation). The statements here attributed to Plato are made by characters in Plato's dialogues, but it is clear from the context in each case that the statements reflect Plato's own views.

[3] *The Republic*, Book II (Jowett translation).

"Then we shall want merchants?"

"We shall."

"And if merchandise is to be carried over the sea, skillful sailors will also be needed, and in considerable numbers?"

"Yes, in considerable numbers."

"Then, again, within the city, how will they exchange their productions? . . ."

"Clearly they will buy and sell."

"Then they will need a market-place and a money-token for purposes of exchange."

"Certainly."

"Suppose now that a husbandman, or an artisan, brings some production to market, and he comes at a time when there is no one to exchange with him—is he to leave his calling and sit idle in the market-place?"

"Not at all; he will find people there who, seeing the want, undertake the office of salesmen." [4]

In *The Laws*, Plato again defends trade. "Retail trade," he writes, "is not by nature intended to do any harm, but quite the contrary; for is not he a benefactor who reduces the inequalities and incommensurabilities of goods to equality and common measure?" Why, then, he asks, has retail trade been "brought into ill-odor?" He answers that it is because the mass of men are selfish; "their desires are unbounded, and when they might gain in moderation they prefer gains without limit; wherefore all that relates to retail trade, and merchandise, and the keeping of taverns, is denounced and numbered among dishonorable things." [5]

On the subject of foreign trade, Plato's ideas are less clear-cut. He appears to have looked upon foreign trade with some distrust and to have regarded self-sufficiency as a laudable goal. The following quotation illustrates his attitude:

The sea is pleasant enough as a daily companion, but has indeed also a bitter and brackish quality, filling the streets with merchants and shopkeepers. . . . There is a consolation, therefore, in the country producing all things at home; and yet, owing to the ruggedness of the

[4] *The Republic*, Book II.

[5] *Laws*, Book XI.

soil, not providing anything in great abundance. Had there been abundance, there might have been a great export trade, and a great return of gold and silver; which, as we may safely affirm, has the most fatal results on a state whose aim is the attainment of just and noble sentiments.[6]

This passage is in harmony with Plato's tendency to subordinate economic affairs to other "higher" interests. While not wishing a thriving foreign commerce, Plato nevertheless favored free trade.

Let no one pay any duty either on the importation or exportation of goods; and as to frankincense and similar perfumes, used in the service of the gods, which come from abroad, and purple and other dyes which are not produced in the country, or the materials of any art which have to be imported, and which are not necessary—no one should import them; nor, again, should any one export anything which is wanted in the country.[7]

The views of Aristotle (384-322 B.C.) on trade are very similar to those of Plato. Like Plato, Aristotle did not have a high opinion of the making of money, holding that "it was easy for philosophers to be rich if they chose it, but that that was not what they aimed at." [8]

Anticipating Adam Smith by over two thousand years, Aristotle clearly distinguished between money and wealth. He asserted that "wealth is very often supposed to consist in the quantity of money which any one possesses, as this is the medium by which all trade is conducted and a fortune made"; but pointed out that "he who abounds in money often wants necessary food; and it is impossible to say that any person is in good circumstances when with all his possessions he may perish with hunger." [9]

The early Christian philosophers accepted the advantages of trade and gave trade a theological basis. They proclaimed that God made the different regions to have different resources and products so that men could have trade relations one with another

[6] *Laws*, Book IV.
[7] *Laws*, Book VIII.
[8] Aristotle, *Politics* (translation by William Ellis), Book I, chap. xi.
[9] *Ibid.*

and thereby become a united and harmonious community, helping each other and living in brotherly love under one God. This religious aspect of international trade doctrine, that trade is ordained of God and that men are in need of each other's aid, had a long history, and was even used by mercantilists and later writers, when convenient, to lend support to their views. At the same time the Church regarded trade with some misgivings, particularly during the Middle Ages.

Medieval Thought.—The economic thought of the Middle Ages is found largely in the writings of the Church fathers. They did not write treatises on economics, as such, but touched upon economic subjects in dealing with broader issues. During the early Middle Ages, when economic life was marked by a high degree of local self-sufficiency, trade was regarded with suspicion by leaders of the Church, such as Chrysostom (*c.* 345-407) and Cassiodorus (*c.* 490-585), who felt that trade for gain was in essence sinful. Trade was by its very nature barren, and traders did not produce anything. With the rise of towns and the emergence of a large merchant class, this distrust of trade gradually broke down. The revival of interest in the writings of the Greeks, which opened the Renaissance, greatly influenced the thinkers of the Church, and the resulting mixture of Christian doctrine and Greek thought (particularly that of Aristotle) is known as scholasticism.

The greatest of the scholastic writers was Thomas Aquinas (1225-1274). His famous work, the *Summa Theologica,* contains his ideas on trade. He regarded trade with favor, holding that "buying and selling seem to have been instituted for the common advantage of both parties, since one needs something that belongs to the other, and conversely, as explained by the Philosopher [Aristotle]."[10] Aquinas devoted much space to a discussion of the conditions under which trade is just or unjust. He dealt with such questions as "whether a man may lawfully [i.e., justly] sell a thing for more than it is worth," "whether

[10] *Summa Theologica,* Question LXXVII, as quoted in Arthur Eli Monroe, *Early Economic Thought* (Cambridge, Mass.: Harvard University Press, 1924), p. 54.

a sale is rendered unlawful by a defect in the thing sold," and "whether a seller is bound to declare a defect in a thing sold."[11] In answering these questions, he was guided by the medieval doctrine of the "just price." It was believed by medieval thinkers that for every article there is a just price, above or below which the article should not be sold. The just price, according to this doctrine, is that which covers cost of production but no more. In reply to the question "whether in trading it is lawful to sell a thing for more than was paid for it," Aquinas declared that such action is legitimate if the seller "has improved the thing in some way" or if "the price has changed with a change of place or time" or if there is risk "in transporting the thing from one place to another."[12]

Origin and Nature of Mercantilism.[13]—The earliest extensive body of literature dealing with the theory of international trade appeared in connection with the ideas of the so-called mercantilists, who date from the sixteenth to the latter part of the eighteenth centuries. The mercantilists were statesmen and economic thinkers in England and on the Continent who developed certain doctrines regarding the state, commerce, the precious metals, and other matters. They placed special stress upon the condition of a country's foreign trade. Their ideas, now regarded as largely fallacious, found expression in governmental policies and actions.

In order to understand the nature of mercantilism, it is necessary to know something of the historical setting out of which it emerged. Economic life during the Middle Ages was almost entirely of a local nature. Each feudal manor and each town was a self-sufficient unit, in which was produced almost all that was consumed. Such trade as existed, domestic as well as foreign, was on a relatively small scale, and was confined largely to luxuries. Trade was hindered from expanding by various types of restrictions and barriers, particularly on the

[11] The clauses in quotation marks are titles of sections in the *Summa Theologica.*

[12] *Summa Theologica,* Question LXXVII, as quoted in Monroe, *op. cit.,* p. 64.

[13] See also Chapter 7, "Balance of Payments."

Continent. Each town attempted to control the trade of the surrounding countryside and to obstruct the trade of competing towns. The free flow of goods was impeded by numerous tolls on rivers, highways, and at provincial boundaries. On the main rivers were toll stations ordinarily every six to nine miles; on the Rhine, the main trade route in central Europe, there were in the fourteenth century over sixty such stations.[14]

The economic philosophy of the Middle Ages thus emphasized local self-sufficiency. Well before the end of this period, however, forces were operating to change this situation. The Crusades, the discovery of the New World, the development of a monetary economy, and other events led to the breakdown of local self-sufficiency and to the rise of strong national states, first Spain and Portugal, then Holland, France, and England. The emergence of the mercantilist philosophy coincided with these developments. The essence of mercantilism, according to Gustav Schmöller, was "state-making" by means of policies aimed to bring about national economic unity.[15] Thus mercantilist statesmen, such as Colbert in France, worked assiduously for the removal of barriers to local trade, endeavoring to establish a vigorous nationalism in the place of deeply rooted localism.

A central motive of mercantilism, then, was to achieve a powerful and wealthy state. The interests of the individual—particularly the interests of the laboring classes—were subordinated to this end. Private endeavor was subjected to numerous regulations and restrictions which were thought to advance the well-being and strength of the state. Wages were fixed by the state as were many prices. The state decided who should work, what should be made, and how it should be made. Infractions were severely punished. France went especially far in curbing individual freedom and in controlling commerce and industry.

[14] Eli F. Heckscher, *Mercantilism* (London: George Allen & Unwin, Ltd., 1935) I, 57. This comprehensive treatise is useful for those who are interested in a detailed treatment of mercantilist thought and practice.

[15] Schmöller, *The Mercantile System and Its Historical Significance* (1884); reprinted in English by Peter Smith, New York, 1931, p. 50.

A cardinal mercantilist doctrine was that a nation, to be strong and prosperous, should have a large amount of gold and silver, or treasure as it was called. The reasons which the mercantilists advanced for this belief vary, and are at times contradictory. Some writers, stressing the desirability of thrift, held that the precious metals represented the most permanent, most liquid, and most dependable form of wealth. These writers tended to think of money as synonymous with wealth. Others held that a large supply of money resulted in low interest rates, which were regarded as important for prosperity.[16] Some mercantilists also favored an expanding monetary supply as a means of maintaining business at peak levels, although they were not familiar with multiplier analysis. These writers stressed the need for keeping money in continuous circulation.[17]

In order to secure as large a supply of the precious metals as possible, mercantilists held that merchandise exports should exceed merchandise imports in value, so that a continuous inflow of bullion would result. This they called a "favorable" balance of trade, whereas an excess of merchandise imports was called an "unfavorable" balance. This terminology has continued to the present day, and is at times the source of popular misconceptions.

An excess of exports over imports was also advocated as a means of increasing domestic employment. Imported goods, it was held, are produced by foreign rather than by domestic labor, and in many cases compete with products made by home labor. To achieve a maximum of domestic employment, it was there-

16 For a sympathetic interpretation of mercantilism, concerned particularly with the mercantilist attitude toward interest rates and related matters, see John Maynard Keynes' chapter, "Notes on Mercantilism, etc.," in his *General Theory of Employment, Interest, and Money* (New York: Harcourt, Brace & Co., 1936). Keynes' treatment of mercantilism should be compared with the less favorable studies of Heckscher (*op. cit.*) and of Jacob Viner (*Studies in the Theory of International Trade* [New York: Harper & Bros., 1937], chaps. i and ii).

17 For example, Charles Davenant, a British mercantilist, wrote in 1698 that "there must be a quick stock [of money] running among the people; and always where that stock increases, the nation grows strong and powerful." Quoted in Heckscher, *op. cit.*, II, 218.

fore maintained that exports should be as large, and imports as small, as possible. On similar grounds, mercantilists argued that, so far as possible, exports should consist of manufactured goods rather than raw materials, since manufactured goods employ more labor and command higher prices.

To achieve a favorable balance of trade, mercantilists were thorough-going protectionists. In an effort to keep imports at a minimum, heavy tariffs and other restrictions were therefore imposed. At the same time, export industries were given bounties and other forms of encouragement. Shipping was also subsidized in order to help stimulate foreign trade.

The colonial policy of the mercantilists has been discussed in a previous chapter.[18] Colonies were regarded by mercantilists as sources of raw materials and as markets for the manufactures of the mother country. To prevent colonial trade from being diverted to other countries, strict navigation laws were enacted, and powerful commercial companies established.

Mercantilists as a group were little concerned with the welfare or living standards of the masses or with social questions. In fact, they advocated a large population to insure low wages, and not only condoned but extolled child labor, on the grounds that it would make children industrious and also keep them out of mischief.[19] Their main emphasis was on selling rather than on buying, on money rather than on goods, and on national power rather than on individual welfare. It is little wonder that Adam Smith accused the mercantilists of preaching a doctrine which was merely a program to enrich the merchant and manufacturer at the expense of the general public.

British Mercantilists.—British mercantilism was of a somewhat more moderate character than that on the Continent. Its chief emphasis was upon the promotion of foreign trade rather than upon the minute regulation of domestic industry; thus it differed considerably from mercantilist thought and practice in

[18] Chapter 2, "History of International Trade."

[19] An interesting discussion on this subject is found in Heckscher, *op. cit.*, II, 155-57.

France. A principal reason for this difference is the fact that local barriers to domestic trade had been largely eliminated in England by the end of the thirteenth century, while in France they persisted until after the French Revolution.

In England, mercantilist writers were not, as a rule, academic men or statesmen but rather merchants and manufacturers. This fact lends support to Adam Smith's interpretation of mercantilism as a doctrine inspired by producer self-interest.

One of the earliest important British writers on mercantilism was Gerald Malynes, whose chief volume on foreign trade was published in 1622. Malynes' work is typical of early mercantilist thought in its emphasis on the importance of money. He held that money possesses "intrinsic" value.[20] Contending that exportation of the precious metals was harmful to a country's trade, he advocated that government have a monopoly over foreign exchange transactions and prohibit the export of bullion by law. His work contains many of the cruder fallacies of mercantilism.

The writings[21] of Thomas Mun (1571-1641) reveal a considerably clearer understanding of the nature of international trade. While Mun shared with many mercantilists a tendency to regard money and wealth as identical, he did not, like Malynes, advocate prohibition of specie exports. On the contrary, he held that the exportation of gold and silver was not harmful if it was merely temporary and if it did not interfere with an excess of merchandise exports. Mun argued that the proper way to increase a nation's supply of the precious metals was through a favorable balance of trade. He wrote:

> I will take that for granted which no man of judgment will deny, that we have no other means to get treasure but by foreign trade, for mines we have none which do afford it, and how this money is gotten in the managing of our said trade I have already showed, that it is done

[20] Like many mercantilists, however, Malynes was not unaware of the effect of the quantity of money on prices. He wrote that "plenty of money maketh generally things dear, and scarcity of money maketh likewise generally things good cheap." From Malynes' *Treatise of the Canker of England's Common Wealth* (1601), as quoted in Viner, *op. cit.*, p. 41.

[21] *A Discourse of Trade* (1621); *England's Treasure by Foreign Trade* (written about 1630; published posthumously in 1664).

by making our commodities which are exported yearly to overbalance in value the foreign wares which we consume. . . .[22]

Although not the first to recognize the existence of invisible items in the balance of international payments, Mun, writing about 1630, listed most of the items that would now be included.[23]

The next British mercantilist writer of prominence was Sir William Petty (1632-1687), whose views are similar to those of Mun. With Mun, he attached the utmost importance to money, and advocated its increase through a favorable balance of trade. His emphasis upon the importance of the precious metals is revealed in the ensuing quotation, which is typical of mercantilist thought:

> The great and ultimate effect of trade is not wealth at large, but particularly abundance of silver, gold, and jewels, which are not perishable, nor so mutable as other commodities, but are wealth at all times, and all places; . . . so as the raising of such, and the following of such trade, which does store the country with gold, silver, jewels, etc., is profitable before others.[24]

Petty was what might be called a moderate mercantilist, and some of his opinions foreshadow the liberal doctrines of Adam Smith. In his *Treatise of Taxes and Contributions* (1662), he wrote:

> We must consider in general, that as wiser physicians tamper not excessively with their patients, rather observing and complying with the motions of nature than contradicting it with vehement administrations of their own, so in politics and economics the same must be used.[25]

The views of Sir Josiah Child (1630-1699) are of interest because they represent the opinions of one of the leading merchants of that time. Child was Governor of the British East India Company, and was an ardent mercantilist. His vigorous assertions on matters of trade state in clear form the principal

[22] *England's Treasure by Foreign Trade,* as quoted in Arthur Eli Monroe, *op. cit.*, p. 171. Spelling in these quotations has been modernized.

[23] *England's Treasure by Foreign Trade,* chap. xx.

[24] *Essays in Political Arithmetic* (1665).

[25] Quoted in Viner, *op. cit.*, p. 98.

doctrines of English mercantilism. "Foreign trade," he wrote, "produces riches, riches power; power preserves our trade and religion." [26] In common with other mercantilists, he advocated a large population; "it is in multitudes of people, and good laws, such as cause an increase of people, which principally enrich any country." [27] He also contended that trades involving the greatest amount of shipping should receive most encouragement, because "the freight, which is in such trades often more than the value of the goods, is all profit to the nation." [28] Particularly characteristic of mercantilist thought is Child's statement concerning the relative value to a nation of various types of labor. He declared:

> It is (I think) agreed on by all that merchants, artificers, farmers of land and such as depend on them . . . are the three sorts of people which by their study and labor do principally if not only, bring in wealth to a nation from abroad; other kinds of people, viz. nobility, gentry, lawyers, physicians, scholars of all sorts, and shopkeepers, do only hand it from one to another at home.[29]

Continental Mercantilists.—The theory of mercantilism appears to have been first systematically developed by an Italian, Antonio Serra. Serra's *Brief Treatise on the Causes Which Can Make Gold and Silver Plentiful in Kingdoms Where There Are No Mines* was published in 1613. In it, Serra argued that a country without gold and silver mines could secure these metals only by achieving an excess of exports of raw products or manufactures. Exports, he contended, should preferably be manufactures, since these command higher prices.

In France, mercantilist practices were probably carried to greater extremes than in any other country. Under Colbert (1619-1683), Controller-General of the Finances under Louis XIV, industry was subjected to minute regulation. The state decreed who could work, what could be manufactured, and what materials and processes could be used. Machines were broken and products burned which did not comply with the rules. In

[26] Quoted in Viner, *op. cit.*, p. 112.
[27] Child, *A Discourse about Trade* (1690).
[28] *Ibid.*
[29] *Ibid.*

many cases, artisans were not free to choose the location where they might establish themselves. As a partial compensation for these measures, technical schools were established, canals built, and a large portion of the internal trade barriers were abolished. At the same time, tariffs on imports from abroad were levied which practically excluded foreign manufactures. Colbert regarded the state as an entrepreneur, whose function it was to direct and apportion the resources of a nation in much the same fashion as a businessman would manage the affairs of his own firm.

In Germany, mercantilist doctrines were expounded by the so-called cameralists (derived from camera, meaning a prince's treasury or public office). Unlike English mercantilists, whose opinions appear chiefly in pamphlets or short volumes, the cameralists expressed their ideas in large comprehensive treatises, which were concerned not only with economic matters but with the science of government, law, technology, mining, and related subjects. In common with British and French mercantilists, the cameralists advocated a large population, and regarded the precious metals as the most desirable form of wealth. In a typically cameralist work, *Austria over All* (1684), Philipp von Hörnigk (1638-1712) laid down nine "fundamental rules of national economy," which reveal something of the general tenor of German mercantilism. These nine rules for the building of a strong state were:

First, to inspect the country's soil with the greatest care, and not to leave the agricultural possibilities of a single corner or clod of earth unconsidered. . . . Second, all commodities found in a country, which cannot be used in their natural state, should be worked up within the country. . . . Third, . . . attention should be given to the population, that it may be as large as the country can support. . . . Fourth, gold and silver once in the country . . . are under no circumstances to be taken out for any purpose . . . or allowed to be buried in chests or coffers, but must always remain in *circulation*. . . . Fifth, the inhabitants of the country should make every effort to get along with their domestic products. . . . Sixth, in case the said purchases were indispensable . . . they should be obtained from these foreigners at first hand . . . in exchange for other domestic wares. . . . Seventh, such foreign commodities should in this case be imported in unfinished form.

. . . Eighth, opportunities should be sought night and day for selling the country's superfluous goods to these foreigners in manufactured form. . . . Ninth, except for important considerations, no importation should be allowed under any circumstances of commodities of which there is a sufficient supply of suitable quality at home. . . .[30]

Adam Smith; Decline of Mercantilism and Rise of Economic Liberalism.—The year 1776 marked the publication by Adam Smith (1723-1790), of his well-known economic treatise, *An Inquiry into the Nature and Causes of the Wealth of Nations.* The target of this lengthy volume was the "mercantile system," which the author subjected to searching and pitiless scrutiny.[31] Smith was professor of moral philosophy at the University of Glasgow, and is frequently referred to as "the founder of political economy." He owed, however, a great deal to his predecessors, particularly to David Hume and Josiah Tucker.

The time was ripe for a bold attack upon the dogmas of mercantilism. The system was already tottering, though perhaps few sensed that its days were numbered. During the second half of the eighteenth century, machines were invented and processes developed which were to revolutionize industry, bringing undreamed benefits, and also problems. If mercantilism, as Schmöller suggested, represented a transition from local to national economy, the industrial revolution released forces which were to operate in the direction of world economy. Mechanical processes were introduced which, to be profitable, made necessary detailed division of labor and vastly increased markets to absorb the vastly increased output. In the face of these developments, the restrictionist policies of mercantilism which hampered the expansion of trade and production were to fall of their own weight. At the same time, the doctrines of Adam Smith and his predecessors were to form the basis of the new policy of noninterference, or laissez faire.

The transition from mercantilism to a philosophy of greater freedom, which is known today as economic liberalism, was a

30 As quoted in Monroe, *op. cit.*, pp. 223-25.

31 It is interesting to note that the title of Smith's book is similar to those of a number of mercantilist works. This reflects the fact that Smith was in sympathy with the mercantilist goal of a strong, wealthy state, though in emphatic disagreement with the means which mercantilists advocated toward this end.

logical outgrowth of the rise of industry and of a wealthy business class. An expansion of industry and markets required freedom and opportunity rather than the limitations imposed by the regulations of mercantilism. The philosophy of laissez faire and individualism, which facilitated economic expansion although sometimes in a harsh and ruthless manner, was widely accepted by the end of the eighteenth century. Adam Smith played a leading role in the development of this thinking and in the shift from the mercantilist philosophy to that of economic liberalism.

Political liberalism as urged by John Locke and others, which taught that men were equal and had certain natural rights of life, liberty and property, developed alongside of and was closely related to economic liberalism. The consequences in both the economic and political field of the philosophy of freedom were profound.

Smith's contribution to economic thought is of both a negative and a positive character. On the negative side, he dealt a death-blow to mercantilist doctrines in the English-speaking world, even though these doctrines were already beginning to fall into disrepute. One or two quotations will reveal the character of his verbal attack, in which he accused the mercantilists of selfish, ulterior motives. He wrote:

> It cannot be very difficult to determine who have been the contrivers of this whole mercantile system; not the consumers, we may believe, whose interest has been entirely neglected; but the producers, whose interest has been so carefully attended to; and among this latter class our merchants and manufacturers have been by far the principal architects.[32]

Smith devoted much space to a condemnation of the mercantilist preoccupation with money in preference to other forms of wealth. He stressed repeatedly that money is of value solely as a means for satisfying wants and in itself is of no significance. In an ironic vein, he declared:

> It is not for its own sake that men desire money, but for the sake of what they can purchase with it. Consumable commodities, it is said,

[32] *Wealth of Nations* (Everyman's edition), Bk. IV, chap. viii (II, 156).

are soon destroyed; whereas gold and silver are of a more durable nature, and, were it not for this continual exportation, might be accumulated for ages together, to the incredible augmentation of the real wealth of the country. Nothing, therefore, it is pretended, can be more disadvantageous to any country than the trade which consists in the exchange of such lasting for such perishable commodities. We do not, however, reckon that trade disadvantageous which consists in the exchange of the hardware of England for the wines of France and yet hardware is a very durable commodity, and were it not for this continual exportation might, too, be accumulated for ages together, to the incredible augmentation of the pots and pans of the country.[33]

The chief positive contribution of Smith to the theory of international trade was an impressive exposition of the benefits of international specialization and division of labor, and, consequently, of free trade. Smith clearly perceived that freedom of trade facilitates specialization in the production of those goods for which a country is best fitted, making possible a higher standard of living. He wrote:

By means of glasses, hotbeds, and hot walls, very good grapes can be raised in Scotland, and very good wine too can be made of them at about thirty times the expense for which at least equally good can be brought from foreign countries. Would it be a reasonable law to prohibit the importation of all foreign wines merely to encourage the making of claret and burgundy in Scotland? But if there would be a manifest absurdity in turning towards any employment thirty times more of the capital and industry of the country than would be necessary to purchase from foreign countries an equal quantity of the commodities wanted, there must be an absurdity, though not altogether so glaring, yet exactly of the same kind, in turning towards any such employment a thirtieth, or even a three-hundredth part more of either. Whether the advantages which one country has over another be natural or acquired is in this respect of no consequence. As long as the one country has those advantages, and the other wants them, it will always be more advantageous for the latter rather to buy of the former than to make.[34]

In contrast to the mercantilists, Smith held that if men were permitted freely to pursue their private economic interests in

[33] *Op. cit.*, Book IV, chap. i (I, 385).
[34] *Op. cit.*, Book IV, chap. ii (I, 402-3).

their own way, the economic interests of society would be served in the most effective possible manner—far more effectively than under a restrictive system. He summarizes this argument in a famous paragraph:

As every individual, therefore, endeavors as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labors to render the annual revenue of society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it . . . by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. . . . By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.[35]

Smith's influence upon his contemporaries was great. While it would not be true to say that his doctrines were responsible for the overthrow of the mercantile system, the spread of his ideas did much to hasten its downfall. British political thought and policy during the nineteenth century were profoundly affected by Smith's views. *The Wealth of Nations* had a great influence upon British commercial policy and also played an important part in shaping the thinking of most of the theorists considered in the next chapter. His theories provided the basis for the so-called "classical economics" which dominated economic thinking until recent years.

[35] *Ibid.*, Book IV, chap. ii (I, 400).

Chapter 14

HISTORY OF INTERNATIONAL TRADE THEORY—THE ENGLISH CLASSICAL SCHOOL

In the preceding chapter, the evolution of international trade theory and the beginnings of so-called "classical economics," as it concerned foreign trade, were briefly traced up to the close of the eighteenth century. The present chapter deals with developments in trade theory made by the English [1] "classical school" during the nineteenth century. Until recent years, the English classical theory of international trade was almost universally accepted. It had been modified and refined, but was essentially that of Smith, Ricardo and Mill. Although writers on the Continent vigorously denied various assumptions and conclusions of the English school, they did not succeed in building a comprehensive rival theory. Their work was mainly of a critical or negative character.

David Ricardo.—Outstanding in the development of classical theory was David Ricardo (1772-1823), who built on the teachings of Adam Smith whose contribution to the classical theory was discussed in the previous chapter. Born in England, the son of a Dutch Jew who had settled in England and become wealthy there, Ricardo became a stock broker and acquired a considerable fortune of his own by the time he was twenty-five. He later devoted much of his time to the study of economic questions, and for a while served as a member of Parliament, where his advice was frequently sought on financial matters. His *Principles of Political Economy and Taxation,* containing his views on foreign trade, was published in 1817. Ricardo's contribution to the theory of international trade was noteworthy,

[1] The English classical school included Irish and British writers.

and a large part of subsequent work in this field by British and American economists consisted of refinements or modifications of the Ricardian theories.

In his analysis of domestic trade, Ricardo adhered to a labor theory of value, which has long since been discarded by economists. He held that the value of a good is proportional to the amount of labor expended in its production; that where free competition prevails, the ratios at which goods exchange are determined by the relative amounts of labor required for their production. An article which requires twice as much labor to produce as another would, according to this doctrine, sell for twice the price. Values, i.e., exchange values, were considered as determined by costs of production; and costs were resolved into amounts of labor.[2]

On the basis of this theory of value, Ricardo made a sharp distinction between domestic and foreign trade. Within a single country, he maintained, goods would exchange at ratios which reflected the labor costs of the goods. This would come about as a result of free competition and unrestricted movement of labor and capital. Thus if an article sold at a price which was high in relation to its labor costs, competition to produce and sell the article would force the price down. Labor and capital would flow to the industry or locality where prices were high, and thereby keep prices in harmony with costs, i.e., labor costs. This condition of free competition and mobility of labor and capital within a country being assumed, Ricardo held that all domestic production and trade would be on a basis of absolute advantage, though he did not use this term. That part of a country which could produce a particular good with the smallest amount of labor would specialize in the production of that good (since no other region could compete successfully), exchanging it for goods from other areas which would also produce under conditions of absolute advantage. Labor and capital would flow to those industries and locations where the advantages were the greatest.

[2] Ricardo was conscious of the existence of differences in the quality of labor, as well as of differences in reward, in various occupations in the same country.

Trade between countries, however, Ricardo maintained, is of a fundamentally different character, being governed neither by labor cost nor, necessarily, by absolute advantage. He wrote:

> The same rule which regulates the relative value of commodities in one country does not regulate the relative values of the commodities exchanged between two or more countries. . . . The labor of 100 Englishmen cannot be given for that of 80 Englishmen, but the produce of the labor of 100 Englishmen may be given for the produce of 80 Portuguese, 60 Russians, or 120 East Indians.[3]

How is this difference to be explained? It results, said Ricardo, from the fact that capital and labor do not flow freely across national boundaries.

> Experience . . . shows that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which every man has to quit the country of his birth and connections, and entrust himself, with all his habits fixed, to a strange government and new laws, check the emigration of capital. These feelings . . . induce most men of property to be satisfied with a low rate of profits in their own country, rather than seek a more advantageous employment for their wealth in foreign nations.[4]

If capital and labor flowed freely from one country to another in response to changes in profits and wages, international trade in commodities, if free, would not differ essentially from domestic trade. All commodities would be produced under conditions of absolute advantage, and would be exchanged, according to Ricardo, at ratios corresponding to the relative quantities of labor involved in their production. Labor and capital would leave a poor country that had no advantages, and seek countries where advantages were greater. The lack of such a free flow of the factors of production between different countries, however, alters the picture. Goods of one country, requiring a large quantity of labor to produce, may exchange for goods of another country requiring but a small amount of

[3] *Principles of Political Economy and Taxation* (London: G. Bell & Sons, Ltd., 1932), chap. vii, pp. 113, 116.
[4] *Op. cit.,* pp. 116, 117.

labor. Plainly, labor cost does not govern the terms of exchange in foreign trade. What, then, determines these terms? The answer, according to Ricardo, is *comparative* cost.

Ricardo's chief contribution to the theory of international trade is his exposition of this concept.[5] According to the doctrine of comparative costs, each country tends to specialize and to export commodities in the production of which it has a comparative (not necessarily an absolute) advantage. This advantage is measured in terms of real costs, which are resolved into labor costs, consistent with the labor theory of value.

Ricardo explained this principle by means of a simple illustration involving two countries, England and Portugal, and two commodities, cloth and wine. Assume, said Ricardo, that a given quantity of cloth requires 100 days of labor to produce in England and 90 days of labor to produce in Portugal. Assume also that a given quantity of wine requires 120 days of labor to produce in England and 80 days of labor in Portugal. In this situation, it would pay England to specialize in the production of cloth and exchange it for wine, since she could thus acquire, with 100 days of labor, wine that it would take 120 days of labor to produce in England. At the same time, it would pay Portugal to specialize in the production of wine and exchange it for cloth, since Portugal could thus acquire with 80 days of labor cloth that would take 90 days of labor to produce in Portugal. It is advantageous for Portugal to specialize in wine, even though she has an absolute advantage in the production of both commodities—that is, even though she can produce both articles with a smaller expenditure of labor than can England.

Here we have a situation where trade is profitable, not because of absolute advantage, but because of comparative ad-

[5] Ricardo himself did not use the term "comparative cost." There has been some debate as to whether credit for introducing the concept of comparative advantage as opposed to absolute advantage should be given to Ricardo or to Robert Torrens. Torrens had presented a fairly satisfactory statement of the doctrine in an essay published in 1815, two years before the appearance of Ricardo's treatise. Professor Viner, admitting the priority of Torrens' statement, writes: "It is unquestionable, however, that Ricardo is entitled to the credit for first giving due emphasis to the doctrine, for first placing it in an appropriate setting, and for obtaining general acceptance of it by economists." (*Studies in the Theory of International Trade,* p. 442.)

vantage. Each country, Ricardo noted, secures more through specialization and trade than if it failed to specialize, even though one of the countries, England, produces and exports a commodity (cloth) which can be produced at absolutely lower cost (real cost) elsewhere, while the other country, Portugal, does *not* produce a commodity (cloth) when it has an *absolute* advantage (lower real cost), in its production. This situation of trade based on comparative advantage would disappear, Ricardo pointed out, were capital and labor to flow freely between the two countries. In the latter event, capital and labor would migrate to Portugal so long as conditions for production there were more advantageous than in England. After capital and labor ceased to flow, specialization and trade would still very likely continue due to variations in resources and other conditions, but it would be on a basis of absolute rather than comparative advantage.

Ricardo thus showed clearly that international trade need not be on a basis of absolute advantage. A country may find it profitable to specialize in the production of goods which can be produced with far less effort elsewhere, or, on the other hand, may find it comparatively unprofitable to specialize in the production of goods in which it has an absolute advantage, since it may have a still greater advantage in other goods. Only in a general way did Ricardo relate comparative advantages to the distribution of the factors of production. He laid the groundwork, however, for subsequent analysis of the relative scarcity of the factors and of how they are combined.

Significant as Ricardo's contribution is, it leaves unanswered the important question of how the actual ratios at which goods exchange are determined. Furthermore, the emphasis upon cost, particularly labor cost, is misleading and inaccurate, as will be seen in the next chapter. In his illustration, Ricardo helped to explain the conditions under which specialization and trade would be profitable—that is, why trade would take place—but he did not explain how the actual terms of trade are determined—that is, why just so many yards of cloth trade for so many bottles of wine. This latter task was undertaken by J. S. Mill.

John Stuart Mill.—John Stuart Mill (1806-1873) began to write on economic subjects at an early age, and became one of the outstanding thinkers of the nineteenth century. As a boy, he was acquainted with Ricardo, who was an intimate friend of Mill's distinguished father, James Mill. Mill's notable work, *Principles of Political Economy,* published in 1848, went through many editions and was long used as a text in colleges and universities. This treatise contains Mill's principal work in the field of international trade, some of the material having been previously published in his *Essays on Some Unsettled Questions of Political Economy* (written in 1831; published in 1844).

Mill's work rests upon the foundations laid by Ricardo, in fact much of it is merely a restatement of Ricardian doctrines. Mill began his analysis of international trade with a careful explanation of the principle of comparative costs. Goods are imported, he declared, because "it is cheaper to import than to produce them." But why is it cheaper to import them? When several commodities are produced in the same locality, he said, one is cheaper than another because it can be produced with less labor and capital—that is, at less real cost. This condition of lower real cost, however, is not necessarily the reason for the cheapness of imported goods. Imported goods frequently come from countries where costs in terms of effort and sacrifice are much greater than in the importing country. Such a situation persists because capital and labor do not flow freely from one country to another. A country with high real costs, wrote Mill,

> would export articles of some sort, even to places which could make them with less labor than itself; because those countries, supposing them to have an advantage over it in all productions, would have a greater advantage in some things than in others, and would find it to their interest to import the articles in which their advantage was smallest, that they might employ more of their labor and capital on those in which it was greatest.[6]

Thus, in Mill's words, "it is not a difference in the *absolute* cost of production, which determines the interchange, but a difference in the *comparative* cost." [7]

[6] *Principles of Political Economy* (5th London ed.), Bk. III, chap. xvii.
[7] *Ibid.,* Book III, chap. xvii.

Mill next proceeded to dispose in summary fashion of the fallacy that international trade is carried on in order to rid countries of their "surplus" goods. According to Mill, this error is a relic of mercantilist thought. Even Adam Smith, he pointed out, was not wholly free from it.[8] Mill wrote:

> The expression, surplus produce, seems to imply that a country is under some kind of a necessity of producing the corn or cloth which it exports; so that the portion which it does not itself consume, if not wanted and consumed elsewhere, would either be produced in sheer waste, or if it were not produced, the corresponding portion of capital would remain idle, and the mass of productions in the country would be diminished by so much. Either of these suppositions would be entirely erroneous. The country produces an exportable article in excess of its own wants, from no inherent necessity, but as the cheapest mode of supplying itself with other things.[9]

Mill's chief contribution to the theory of international trade was his principle of reciprocal demand, a statement of the principles which, according to Mill, establish the terms of trade. Ricardo, it will be recalled, had shown the conditions under which it would be profitable for countries to trade goods, but had not worked out a theory to explain the actual ratios at which goods are exchanged. Within the limits set by comparative costs (that is, within the limits which determine where it would be as cheap for countries to produce goods at home as to import them), there are innumerable ratios at which trade would be mutually profitable for the countries concerned. How are the existing ratios at which trade actually takes place established? This question Mill sought to answer.

In order to simplify the problem, Mill, like Ricardo, confined his analysis to situations involving two countries and two commodities, which later economists have shown to be the source of difficulty leading to fallacious conclusions. For the purpose of

[8] Thus Smith claimed that one of the "two distinct benefits" of international trade to the countries of the world is that "It carries out that surplus part of the produce of their land and labor for which there is no demand among them, and brings back in return for it something else for which there is a demand. It gives a value to their superfluities by exchanging them for something else. . . ." *Wealth of Nations,* Book IV, chap. i.

[9] *Principles of Political Economy,* Book III, chap. xvii.

illustration, he chose England and Germany, and for commodities, broadcloth and linen. Suppose, said Mill, that before trade had been established between these two countries, in England ten yards of broadcloth exchanged for fifteen yards of linen, while in Germany the same amount of broadcloth exchanged for twenty yards of linen. In this case, it would pay England to exchange her cloth for German linen so long as she could get more than fifteen yards of linen for her ten of cloth. By the same token, it would pay Germany to trade her linen for English cloth if she could obtain ten yards of cloth for anything *less* than twenty yards of linen. There exists, then, a wide margin within which trade between the two countries would be mutually advantageous. At a ratio of ten yards of cloth for nineteen yards of linen, most of the gain would go to England, though Germany would still profit by trade; at a ratio of ten yards of cloth for sixteen of linen, most of the gain would go to Germany, though England would still profit.

What is it, then, that determines (within the limits where trade is profitable) the actual ratios at which goods will be traded? The answer, said Mill, is *reciprocal demand.* If, in the above illustration, the demand of England for German linen were great, while the demand of Germany for English cloth were small, a ratio would be established in which most of the gain from trade would accrue to Germany (for example, a ratio of sixteen yards of linen for ten of cloth). If, on the other hand, German demand for cloth were great while English demand for linen were small, a ratio would be established in which England would secure most of the gain (for example, a ratio of ten yards of cloth for nineteen of linen).

Whatever ratio were established, a condition of equilibrium would be attained, Mill showed, only when the total value of the cloth which England exported equaled the total value of the linen which Germany exported (assuming, of course, that only two goods were traded). If the value of the German linen, for example, were greater, gold would tend to flow from England to Germany, which would tend to raise prices in Germany and lower them in England. This would tend to reduce exports of German linen and increase those of English cloth until the ex-

ports of each country exactly paid for the imports. This tendency toward equivalence Mill referred to as "the equation of international demand." In his words: "The produce of a country exchanges for the produce of other countries at such values as are required in order that the whole of her exports may exactly pay for the whole of her imports." [10]

Mill's theory of reciprocal demand has been criticized by a number of writers. Some of these criticisms we shall consider later. Mill's work, however, remains as having aided greatly in clarifying the intricate problems connected with the theory of international values. Even though his reasoning involved fallacies, he provided additional groundwork on which others could build.

Refinements of Classical Theory.—We have discussed the chief doctrines in the theory of international trade developed by the English classical school. The major parts of this theory, as it existed after the publication of Mill's *Principles,* were, to sum up: (*a*) the principle of international specialization according to natural advantages, as presented by Adam Smith; (*b*) the monetary analysis developed by Hume and expanded by Ricardo, Mill, and others, dealing with the flow of specie and the effects upon price levels [11]; (*c*) the comparative cost doctrine of Ricardo, as contrasted with the earlier and simpler statement of absolute advantage; and (*d*) the principle of reciprocal demand as stated by Mill to explain ratios of trade, and his closely related equation of international demand. We shall now consider various additions and refinements of these classical doctrines made by other British writers of the nineteenth and early twentieth centuries.

An important contribution to the understanding of international wage-level relationships was made by Nassau William Senior (1790-1864), a contemporary of Mill. Senior was concerned with the question of what determines the different levels of money-wage rates in the various countries of the world. He concluded that the level of money wages prevailing within

[10] *Op. cit.*, Book III, chap. xviii.
[11] See Chapter 16.

a country is governed by the productivity of labor in that country's export industries relative to the productivity of labor in the same industries abroad. According to this doctrine, if labor in a country's export industries is more efficient, and therefore productive, than such labor in foreign countries, the level of money wages in the country will be higher than money-wage levels abroad; if, on the other hand, labor in a country's export industries is inefficient relative to such labor abroad, money wages in the country will be low.[12] On the basis of this reasoning, essentially sound as far as it goes, Senior attacked the notion that high money-wage rates are an obstacle to a country's foreign trade. Such a notion, he implied, reverses the true sequence of cause and effect. He wrote:

> It is obvious that our power of competing with foreigners depends on the efficiency of our labor, and it has appeared that a high rate of wages is a necessary consequence of that efficiency. . . . To complain of our high wages is to complain that our labor is productive—to complain that our workpeople are diligent and skillful. To act on such complaints is as wise as to enact that all men should labor with only one hand, or stand idle four days in every week.[13]

The next great classical writer after Mill and Senior was the Irish economist, John Elliot Cairnes (1832-1875), who did much to polish off some of the rough edges of classical doctrine. Cairnes' work in the theory of international trade is found in his treatise, *Some Leading Principles of Political Economy*, published in 1874.

It will be recalled that in the analysis of Ricardo and Mill, the factors determining international values were considered to be distinct from those determining values within a country. The prices of domestic goods were assumed, under the operation of free competition, to be determined by cost of production, while the prices of internationally traded goods were not explained by Ricardo, and in the analysis of Mill were assumed to

[12] Senior interpreted efficiency of labor broadly to include efficiency resulting from "superior diligence," "superior skill," "assistance of a larger capital," "deferring for a longer time remuneration," or "any advantage natural or acquired." From Senior, *Three Lectures on the Cost of Obtaining Money* (1830).

[13] Senior, *op. cit.*

be determined by reciprocal demand, operating within the limits set by comparative cost. Thus for international goods Mill leaned toward a demand and supply approach, whereas for most domestic goods (there were a few exceptions, such as nonreproducible goods) he regarded cost of production as the final answer to the question of price determination. Between the two types of price theory existed a wide gulf. Cairnes, by recognizing the existence within a country of "noncompeting groups," carried domestic price reasoning part way toward a demand and supply concept. Cairnes, however, continued to emphasize cost of production as the price determinant within each group.

Under free competition, said Cairnes, prices of goods are determined by cost of production. But free competition is the exception rather than the rule. Within every country are numerous noncompeting groups of workers. Skilled workers do not compete directly with unskilled workers, professional men do not compete with artisans, doctors with lawyers, and so on. To the extent that free competition does not prevail within a country, it cannot be said that domestic prices, any more than international prices, are determined by cost of production. How, then, are such prices established? According to Cairnes, the prices of all goods produced under conditions other than free competition are determined by "reciprocal demand." He wrote:

> As in international trade an increased demand for the products of other countries will, other things being equal, affect international values—or, let us say, affect the relative prices of the products of different countries—unfavorably for the country whose demand is increased; and as, again, the converse of this condition, an increased demand by other countries for the products of a given country, will operate in the contrary direction; so it will be in the exchanges which take place between non-competing groups. Whatever increases the demand of a given group for the products of outside, that is to say non-competing, industries, or (what comes to the same thing) whatever increases the supply of its products available for the purchase of the products of such industries, will, other things being the same, depress the prices of its products in relation to the prices of the products of the industries against which they are exchanged, and vice versa. . . .[14]

[14] *Some Leading Principles of Political Economy,* p. 90.

Nations, according to Cairnes, are merely large noncompeting groups. In so far as free competition does not exist, the prices of domestic as well as of internationally traded goods are determined in essentially the same way, that is, by reciprocal demand.

Cairnes improved considerably upon Senior's statement of wage and price relationships in the theory of international trade. He declared that a country's money and real wage levels, and the character of its foreign trade, "are co-ordinate effects of a common cause, that cause being the degree and direction in which a nation's industry happens to be productive." [15] High real wages in a country, according to Cairnes, indicate that "high productiveness" prevails in many industries, that a country's labor is in general efficiently engaged. A high level of money wages, Cairnes held, indicates "either rich mines of gold or silver, or a high productiveness of industry in some commodities in large demand abroad with which gold or silver may be purchased on favorable terms." [16]

On the basis of the above reasoning, Cairnes, like Senior, attacked, as "absolutely without foundation," the notion that a high money-wage level makes a country unable to compete abroad and is incompatible with a thriving foreign trade. Such a notion, he maintained, completely confuses cause and effect. Far from being incompatible, high money wages and a large export trade are often found together, since both are evidences of efficient export industries.

Cairnes was the first classical writer to stress the importance of invisible items in a nation's balance of payments. He also discussed the manner in which the industrialization of a country may affect its balance of trade. He distinguished three stages in this evolution: (*a*) a borrowing period, tending to produce an unfavorable balance of trade for the borrowing country, (*b*) an intermediate period in which interest payments offset new capital imports, and (*c*) a period in which interest payments plus capital repayments exceed new loans, establishing a favorable trade balance.[17]

[15] *Some Leading Principles of Political Economy,* p. 339.
[16] *Ibid.,* p. 340.
[17] *Ibid.,* pp. 359-63.

Further refinement of the classical doctrines was made by C. F. Bastable, an Irish economist, whose *Theory of International Trade* was published in 1893. This work is short—less than two hundred pages—but contains much that is new. Bastable tried to make the classical theory of trade more realistic. In his second chapter, entitled "The Theory of International Values," he proceeded to modify various of the rigorous and unreal assumptions underlying the analysis of Ricardo and Mill.

The first assumption he dealt with was that of constant costs. Ricardo and Mill in their studies had tacitly assumed that industry operates on a basis of constant costs (in which costs per unit of output do not change with a change in the rate of output). Under this assumption, an increase or decrease in the demand for a product would not result in any change in the cost of producing a unit of the product. But industry does not ordinarily operate on this principle. Either unit costs tend sooner or later to increase as demand increases, as, for example, sometimes in agriculture, or costs tend to decrease as demand increases, making possible expanded operations, as in much large-scale industry. Where costs are not constant, the limits set by comparative cost will vary with changes in the rate of output. Bastable's principal conclusion on this subject is "that the operation of the law of diminishing return [increasing costs] tends to limit the area of international exchange, while that of the law of increasing return [decreasing costs] is calculated to extend it." [18]

Following the example of Cairnes, Bastable disagreed with the assumption of perfect competition within each country. He also extended his analysis to include situations involving more than two countries and two commodities.

Two men whose original work in this field is significant, but on the whole too detailed for more than summary mention here are Alfred Marshall (1842-1924) and F. Y. Edgeworth (1845-1926). Marshall's studies on international trade appear in a privately printed volume, *The Pure Theory of Foreign Trade*

[18] *Theory of International Trade* (4th ed., 1903), p. 31.

(1879),[19] and in his last work, *Money, Credit, and Commerce,* published in 1923. Edgeworth's contributions are found in his *Papers Relating to Political Economy* (1925), a collection of previous articles and monographs. Both writers leaned heavily upon classical foundations. Both were skilled in diagrammatical and mathematical analysis, which they employed extensively. In order to avoid the unreality of situations involving only two commodities (as in the analyses of Ricardo and Mill), Marshall introduced a new theoretical concept: the "representative bale of goods," embodying a constant quantity of a country's labor and capital. Thus the simple and unreal reasoning based on cloth versus linen, as though these were the only articles traded, was broadened in the endeavor to conform to actual conditions. By means of this tool, Marshall attempted a more generalized exposition of the theory of international trade, though his conclusions based on this method, as well as the method itself, have not met with unanimous assent. Edgeworth devoted himself to a variety of isolated problems in theory. Among his contributions is an elaborate theoretical analysis of the gain from trade.

[19] Reprinted by the London School of Economics, 1930.

Chapter 15

CONTEMPORARY INTERNATIONAL TRADE THEORY

Classical economics dominated international trade theory, especially in Great Britain and the United States, during the nineteenth century and until well after the first World War. At the present time the so-called general equilibrium theory has largely taken over the field, although the modern classical school, which upholds in modified form the doctrines of Smith, Ricardo and Mill, has many adherents. The two lines of thought, as will be seen, lead to basic conclusions not so far apart as might at first appear. While fundamental differences exist, many of the differences are largely matters of emphasis.

Modern Classical Theory.—A number of modern international trade theorists, particularly in England and America, have built upon the foundations laid by Smith, Ricardo and Mill, so that their theoretical analysis may be termed modern classical, or neoclassical.

Modern classical economists begin with an analysis of costs of production as the basis for domestic exchange value. Prices within a country are assumed to reflect, at least approximately, real costs within that country. An article priced twice as high as another is thus assumed to have been produced at twice the cost of the other, costs referring to real costs (disutility). Any discrepancies or irregularities which may exist in the relation of costs to selling prices, ordinarily, it is held, tend to disappear under the influence of free competition. If the price of an article becomes high in comparison to its costs, competition of producers and sellers, it is said, will force the price down, and vice versa.

Classical writers have differed in their interpretation of real costs. Many theorists, following the example of Ricardo, have adhered to a labor-cost analysis, holding, as noted, that domestic exchange values of goods correspond with reasonable accuracy to the relative amounts of labor involved in the goods' production, using labor as representative of general real costs. Others, following Cairnes, have attempted greater realism by taking into account such types of real cost, or disutility, as abstinence and sacrifice. In either case, the foundation is laid for the doctrine of comparative costs.

This doctrine of comparative costs, so important in classical analysis, is used to explain why countries find it to their advantage to specialize in the production of certain commodities while importing others. A country, it is held, exports those commodities in the production of which its comparative real costs are lowest. Comparative costs are a reflection of comparative advantages. The doctrine thus builds on the principle of comparative advantage. Comparative costs are merely a measure of comparative advantages stated in terms of costs, i.e., real costs.

As pointed out in the preceding chapter, the doctrine of comparative costs does not provide an explanation of the precise terms at which goods exchange between countries. It endeavors to show the reasons for specialization and why nations produce certain goods, but does not deal with the terms of trade. To explain these ratios or terms of trade, the concept of reciprocal demand is introduced, according to which a nation with a large demand for foreign goods is ordinarily in a weak or unfavorable position regarding the terms of trade, and vice versa. The exact terms are the result, it is held, of the interaction and relative size and strength of the demands, just as they are in any trade. The theory of demand has been analyzed in detail by certain writers, much attention being given to elasticities of demand.

We have already seen how classical doctrines were refined and extended by British theorists of the later nineteenth and early twentieth centuries. Important in this process of elaboration were Cairnes' treatment of noncompeting groups, and Bastable's refinements, such as his analysis of the effect on trade

of production under conditions of varying cost; also important were the theoretical contributions of Marshall and Edgeworth. Modern classical theorists have pursued, in general, the same fundamental lines, endeavoring to meet situations wherein the theory did not conform to real life.

A leading representative of the classical tradition is F. W. Taussig, for many years professor of economics at Harvard University. Professor Taussig dealt not only with the theoretical aspects of international trade, but made extensive factual studies. His published works in this field include *The Tariff History of the United States* (1888), *Some Phases of the Tariff Question* (1915), *Free Trade, the Tariff, and Reciprocity* (1919), and *International Trade* (1927).

Taussig is noteworthy for the thoroughness of his analysis. His treatment of comparative costs, world wage and price levels, noncompeting groups, capital and interest, varying costs, and other topics employs numerous arithmetical illustrations which is in contrast to the vagueness and obscurity often found in earlier writers. Moreover, his extensive use of descriptive and statistical material gives his work reality in a subject which can easily become remote from the problems of the real world.

Taussig builds his analysis of comparative costs upon a modified labor-cost theory of value. Ricardo, it will be recalled, held that comparative costs are comparative labor costs. Within each country, he maintained, domestically produced goods will tend, under the influence of free competition, to be priced in proportion to the relative amounts of labor time involved in their production. Taussig was of course aware of the objections to a labor theory of value, but held that these criticisms did not prevent the doctrine from being a useful approximation so far as the theory of international trade is concerned.

In support of his labor-cost approach, Taussig resolves all money costs of production into two and only two items, wages and interest. Expense for raw materials, he holds, can be broken down into previous expense for wages and interest, and therefore should not be considered separately as a cost of production. Similarly, the cost of tools consists of payment for labor which made the tools, plus interest. Rent, he says, is not to be con-

sidered a cost of production; it is rather a result than a cause of cost. Rent, in Taussig's words, is "merely a differential element"; for example, in the case of land, rent measures the difference between productive as opposed to less productive land. Rent "stands for the differences in the expenses of production and serves to equalize them." [1]

Taussig then attempts to show that over a wide range of cases, the introduction of interest expense in no way affects a country's comparative cost situation or the course of international trade. He supports his case with a number of arithmetical examples, but his major conclusions may be quoted in a few words. He writes that

> . . . interest on capital acts on international trade not in itself, but only in so far as it operates differently on different commodities. At the very start it is obvious that an interest charge, added uniformly to the expenses of production, brings no alteration in relative prices, since it acts equally on all commodities. Nor does an interest charge have an effect simply because it is at a different rate in the two countries—higher in one than in the other. If within each it acts uniformly throughout, it leaves the relations between the countries undisturbed. Further: an interest charge does not alter the conditions for trade, even though it act on one commodity only, provided it acts on that commodity in the same way in both countries. The same is true . . . if the interest charge, instead of being absent on one article while present on another, is merely greater on one than on another. If the difference is the same in both countries, international trade goes on in the same way as if this factor had not entered.[2]

Following this train of thought, which emphasizes labor costs, Taussig gives considerable attention to the effectiveness of labor and to wage levels, which vary from country to country. He discusses both money wages and real wages, as well as price level relationships. His work in this area is largely a refinement of the doctrines of Senior and Cairnes.

In stating the theory of comparative costs he points out that a country exports those goods which are low in price (cost)

[1] Taussig, *International Trade* (New York: The Macmillan Co., 1927), p. 62.

[2] *Op. cit.*, pp. 65-66.

within its borders (relative to prices of the same goods abroad), and imports goods which would be high in price (relative to prices of the same goods abroad) if domestically produced. Those goods which can be most cheaply produced, and hence exported, tend to be the ones, according to Taussig, in which a country's labor is applied most effectively. The money wages paid by the export industries will be high or low, compared to other countries, Taussig holds, according to the effectiveness of this labor relative to that of other countries. Money wages in export industries will be high if the effectiveness of labor there is great, low if the effectiveness of labor is not great. In either case, however, the level of wages paid by the export industries will tend to set the pace for wages in the other industries within a country. If domestic industries are to get efficient workers, they must meet the wage rates prevailing in the export industries which tend to get the most efficient workers.

Whether real wages, as opposed to money wages, will be high or low will depend, according to Taussig, upon the general effectiveness of a country's labor as a whole. If labor is highly productive not only in export industries but in domestic industries as well, prices as a whole will be low relative to other countries (since a large amount of goods are produced), and real wages will therefore be high (because of the effectiveness of workers and consequent high money wages). If labor in domestic industries, however, is not very productive, prices of domestic goods will tend to be high (goods scarce), so that despite high money wages (because of efficient export industries), real wages may be low.

Taussig holds that wages and prices within a country tend to move together, a rise in a country's price level being generally accompanied by a corresponding rise in its money-wage level, and a fall in the price level by a fall in the wage level. He emphasizes, however, that high wages do not necessarily mean high prices in general, nor do low wages mean a low price level in general, despite the popular impression to this effect. A high (or a low) money-wage level may exist with either a high or a low price level. Taussig holds that the actual situation in any particular country will depend, as we have just seen, upon the

relative effectiveness of the country's labor as a whole, in both domestic and export industries, as compared with the relative effectiveness of labor abroad.

Taussig asserts that money wages and incomes are an index of a country's terms of trade. High money wages and incomes in a country, relative to money incomes abroad, are, he says, an indication of favorable terms of trade for such a country, since prices of internationally traded goods (barring costs of transportation) are the same the world over, so that high money incomes are an advantage in buying international goods. Low money wages and incomes, on the other hand, indicate unfavorable terms of trade, since a nation with low money incomes is at a disadvantage in buying in the world market.

Taussig says that a country reduces its benefits from trade by erecting tariff barriers against the importation of goods. The benefits from trade being indicated by the relation between money incomes and the prices of imported commodities (the higher the money incomes and the lower the prices of imported commodities, the greater the gain), a rise in the prices of imported commodities induced by a protective policy reduces or completely eliminates the gain from trade.

Lack of space prevents a detailed discussion of other modern classical theorists, although mention should be made of Jacob Viner, whose work has been to a large extent along classical lines.[3] Viner's most significant contributions to this field are found in his *Studies in the Theory of International Trade,* published in 1937. This work contains, in addition to considerable historical material, a detailed examination of the modern exchange mechanism and the theory of international values. Viner gives a critical analysis of the doctrine of comparative costs and the problem of gain from trade. His theoretical work does not lend itself well to summary discussion, but is commended, to those who wish to investigate these matters further, as an acute general treatment of the history of international trade theory.

Criticism of Classical Theory.—The classical approach to international trade theory, like that to domestic value theory, has

[3] British neoclassical writers were discussed in the preceding chapter.

throughout its history been the target of severe attack. Much of the criticism has been directed at the inadequately analyzed assumptions underlying the classical doctrines, such as the assumptions of perfect competition within each country, of complete immobility of labor and capital between countries, but mobility domestically, and of constant costs. Later classical writers relaxed some of the Ricardian assumptions, particularly those just mentioned.

The basic objection to classical theory, however, has not been easily overcome. Ricardo's analysis of international trade, like that of his successors, is built upon the labor theory of value. Domestic values (exchange values), according to Ricardo, are determined by labor costs; international values, by comparative labor costs. Economists have long since discarded the labor-cost theory of pricing, pointing out that goods do not exchange on the basis of labor costs or, for that matter, on the basis of any other kind of costs. The price relationship of goods is very different from the relative amounts of labor required to produce them and not infrequently from their monetary costs of production. The problem must be approached at the other end, namely, on the basis of demand and supply.

The labor theory of value necessarily assumes perfect competition both in the labor market and in the market for commodities, whereas, actually, free competition does not prevail in either area, except perhaps in rare instances. Economic life in industrial nations is to a considerable extent organized on a monopolistic or semi-monopolistic basis; it is characterized by huge corporate productive units, large chain distributing agencies, labor unions, employer associations, agricultural organizations, and various other institutions together with a high degree of governmental control and subsidy, so that such competition as exists is ordinarily far from perfect. Labor and capital, moreover, are relatively immobile and do not move quickly to the best market, which is necessary if competition is to perform its equalizing function and keep prices in strict harmony with costs. Furthermore, many goods and services are unique or are approximately unique, so that there can be no perfect competition for them.

The labor theory of value assumes that labor is a homogeneous factor of production, that an hour's labor, for example, is something definite and uniform. This assumption is obviously unrealistic. Labor is made up of many different qualities and grades, efficient and inefficient, skilled and unskilled, which receive different rates of pay and which, to all intents, are separate factors of production.

Furthermore, the labor theory of value assumes that all money costs of production other than wages either can be identified as previous wages or, if this is not possible, as in the case of interest, can be found combined with wages in approximately the same proportion, so that relative prices are not affected by the varying degree to which costs other than wages are a part of total costs. If all money costs are resolved into wages and interest, for example, it must then be assumed either that interest expense is generally so small as to be inconsequential, or that it is always combined with wage expense in approximately the same proportion. Otherwise, relative prices will be significantly affected by the extent to which interest enters into costs, with the result that the labor theory of value will not give even an approximate explanation of domestic price relationships. These assumptions do not conform to the facts. The most superficial survey of modern industry reveals that interest expense is often large and that products vary widely in the proportions in which labor and capital are combined in their production.[4]

The labor theory of value looks largely to supply and to the forces determining supply. Here it offers an inadequate explanation of what determines supply, namely, that costs of production determine supply, and that such costs are labor costs. It, in general, assumes price as a predetermined and established fact, and reasons that supply is the amount that can be produced

[4] Taussig argues, as noted above, that if the rate of interest is different in two countries, but within each country acts uniformly on all costs, it can be disregarded from the standpoint of its effect upon foreign trade. This overlooks the fact that if costs within a country are raised because of higher interest rates—even though the rates apply uniformly to all costs so that domestic price relationships remain unchanged—this higher cost situation would react unfavorably upon such a country's total exports and therefore upon its terms of trade.

at a cost sufficiently low to meet the given price. Modern value theory on the other hand shifts emphasis from supply, stressing the mutual interdependence of demand, supply, and price. Price is recognized as itself determined, or influenced, by supply and also by demand. These forces are all in equilibrium each affecting the others.

The above considerations are enough to explain why the labor theory of value has been generally abandoned by economists. With reference to the doctrine of comparative costs, in addition to its being based on the labor-cost-price analysis, another main weakness is that trade between countries does not, as the doctrine assumes, take place because of differences in costs, either real costs or even monetary costs. Importers are not interested in the costs of production of goods, but in the prices they must pay. It is the ratios between prices of goods (or money costs, if we were to allow a rigid relationship or identity between money costs and prices, which, however, does not exist) that determine whether trade is profitable. If prices of goods in one country hold the same relationship to each other as prices in another country, no basis for trade exists. For example, if ten yards of cloth exchange for twenty bushels of wheat in both countries, no reason for trade between the countries is present, regardless of the comparative costs in the two countries.

The classical theory of international trade grew up in the storm center of controversy over free trade versus protection, and has always been intimately connected with discussions of trade policy. This helps to explain its preoccupation with such concepts as "gain from trade" and "terms of trade." It is impossible to discuss intelligently the problem of gain from trade without introducing the idea of "real cost," or "effort cost," since the gain from trade is essentially the increase, in terms of effort, of the amount of goods and services secured by trade over the amount which could be obtained without trade. The labor theory of value to a considerable extent facilitated analysis along these lines.

Various theorists, such as Taussig, have held that even if this value doctrine is only a rough approximation to reality, it is a

useful and legitimate analytical tool. Equilibrium theorists, however, declare it misleading, inaccurate, and the source of confusion. It does not explain that which it pretends to explain, therefore it should be discarded and attention directed to a correct explanation. Attempting to patch up a theory which is invalid serves no useful purpose, except, perhaps, satisfying the reluctance to abandon something with a long and prominent history.

Not all classical writers have employed a labor theory of value in their analysis of international trade. For example, Cairnes, in his treatment of comparative cost, wrote in terms not of labor costs but of "human" costs, of which he distinguished two: labor and abstinence. Bastable developed his analysis in terms of "units of productive power." These attempts at greater realism, however, did not get at the root of the trouble. As various critics have shown, this type of approach tries to add together quantities which are incommensurable. Labor and abstinence are both real costs, but they have no common denominator. There is no logical way of stating how many hours of abstinence are equal in disutility to, for example, 10 hours of a certain kind of labor. These costs can no more be added together than can yards and bushels.

While not susceptible of accurate measurement, the concept of real costs, like that of real wages and psychic income, has usefulness, particularly from the standpoint of welfare economics. It does not, however, get us very far in explaining and stating precisely the underlying forces and mechanism of international trade, and can easily lead to confused thinking.

One feature of the classical approach—the two-country, two-commodity assumption—has been criticized in recent years by Frank D. Graham. Professor Graham holds that the typical classical procedure of generalizing from situations involving only two countries and two commodities is misleading, and indicates a greater instability in exchange rates and the terms of trade than actually exists. He shows that since trade includes a wide variety of products and is between several countries, the substitution of the products of one country for those of another

provides a considerable amount of stability in exchange rates and the terms of trade.[5]

He is particularly critical of Mill's analysis and conclusions. Mill, it will be recalled, concluded that where there are two countries and two commodities, the play of reciprocal demand will tend to set the ratio at which the two products are exchanged somewhere between the extreme limits of the range wherein trade is possible, the limits set by comparative cost (that is, between the limits where it would be as cheap for each of the countries to produce the other's specialty as to import it). He held that it was conceivable, but not probable, that the play of demand might set the ratio of exchange at either of these limits, so that all the gain from trade would go to one of the countries and none whatever to the other.

Graham, on the contrary, holds that on the basis of Mill's assumptions, the ratio of exchange will ordinarily rest at one of the extreme limits and only in exceptional cases will it be somewhere between. Only in instances where the two countries are of approximately equal economic importance and the two commodities of approximately equal "total consumption value" will the ratio of exchange, according to Graham, tend to settle between the possible limits and thus divide the gain from trade between the two countries. Graham's reasoning is as follows. In Mill's illustration, it will be recalled that before specialization and trade, ten yards of broadcloth could be produced in England at the same cost as (and hence exchanged for) fifteen yards of linen; while in Germany ten yards of broadcloth could be produced at the same cost as (and hence exchanged for) twenty yards of linen. England's specialty was thus cloth, and Germany's linen. Assuming perfect competition, as Mill did, linen would continue to be produced in England so long as English linen producers received the equivalent of at least ten yards of cloth for their fifteen yards of linen. If the price of linen declined (because of importations from Germany) so that they received only nine yards of cloth for their fifteen of linen, they would shift to the production of cloth, since they would thus

[5] Frank D. Graham, *The Theory of International Values*. Princeton, N. J.: Princeton University Press, 1948.

receive ten yards of cloth for the same effort required to produce fifteen yards of linen for which they could now get only nine yards of cloth. There would, however, be no advantage in shifting away from linen (Germany's specialty) to the production of cloth so long as they received at least ten yards of cloth for their fifteen of linen. Similarly, cloth (England's specialty) would continue to be produced in Germany so long as German cloth producers received the equivalent of not less than twenty yards of linen for their ten yards of cloth. If cloth declined and they received only nineteen yards of linen for their cloth, they would shift to linen. Under any ratio between fifteen and twenty yards of linen for ten yards of cloth, according to Mill, English linen producers would shift to the production of cloth and German cloth producers to the production of linen until England had completely specialized in the production of cloth and Germany in the production of linen.

But suppose, says Graham, that we modify Mill's illustration by substituting for Germany a much smaller country, say Denmark, and assume at the same time that broadcloth and linen are products of approximately equal "total consumption value" —that is, that the total value of the production of each article is about equal.[6] What would happen in this event after trade is opened is clearly stated in Graham's own words:

> . . . paraphrasing exactly Mill's assumptions, with the substitution of Denmark for Germany, let us suppose that trade is initiated at the exchange rate of 10 yards of cloth for 17 of linen. Such a trade must cause a rapid shifting of English production from linen to cloth, and of Danish production from cloth to linen, and, under the assumed conditions, nothing can stop this shifting until it has completely eliminated either the Danish production of cloth or the English production of linen. Since we are supposing that the total value of linen and cloth is in approximate equality, Denmark, as the smaller country, will be completely specialized in linen production while there are, perhaps,

[6] Graham does not explain how the values in a country are to be compared or combined with the values in the other country. If a monetary unit is used, this unit must be in terms of the rate of exchange between the two countries which is itself influenced by the trade which is being explained.

The answer, in which Graham concurs, is that in every situation involving interaction it is impossible to start from a fixed base. Each force influences the others, and if we are to analyze the situation we must break in somewhere.

nine tenths of the English linen producers still left in that business, the specialization by the Danes being sufficient to drive only one tenth of the English linen producers into the making of cloth. In these circumstances the terms of interchange of cloth for linen must move to the extreme most favorable to Denmark, that is to say, 10 cloth for 15 linen; for a supply of linen adequate to the English demand is not obtainable on any better terms, the terms which the English linen producers require if they are to continue their operations.[7]

If the terms, in order to give some of the gain to England, were only nine of cloth for fifteen of linen, none of the English linen producers would find it profitable to produce linen since fifteen of linen required the same amount of work as ten of cloth. It would be easier to get fifteen of linen by producing nine of cloth. They would therefore continue to shift to cloth until ten of cloth traded for fifteen of linen.

Thus two results follow from the substitution of a smaller country: (*a*) the entire gain from trade goes to the smaller country, the larger one being no better off than before trade, and (*b*) the larger country continues to produce both commodities after trade is opened. Denmark secures its entire cloth supply by trading linen for it; England produces a part of its consumption of linen and imports the rest in exchange for cloth.

Graham shows that similar conclusions follow if, instead of substituting a small country for a large country, a commodity of small total consumption, for example, matches, is substituted for one of the commodities in Mill's illustration. Let us, then, substitute matches for linen, and assume that before trade, ten yards of cloth exchange for fifteen crates of matches in England and for twenty crates in Germany. If trade is opened on the basis of ten yards of cloth for seventeen crates of matches, English producers of matches will quickly leave the business and turn to the more profitable business of producing cloth to trade for matches. But since we are assuming that the total consumption value of matches continues to remain smaller than that of cloth, Germany will never be able to find in England a market for matches large enough to pay for her whole consumption of

[7] Frank D. Graham, "The Theory of International Values Re-examined," *Quarterly Journal of Economics*, Nov. 1923, pp. 57-58.

cloth. Hence Germans must continue to produce cloth at home, and German producers will find it profitable to do so only at the old ratio of ten yards of cloth for twenty crates of matches. At this ratio, however, the entire gain from trade goes to England.

Thus Graham concludes that in virtually all trading situations involving only two countries and two commodities, the terms of interchange will settle at one of the two extremes, so that the whole gain from trade will go to one of the countries, the other country being no better off than before trade. The result can be otherwise, Graham holds, only where "the dice are loaded by assuming trade in two commodities of approximately equal total consumption value and between two countries of approximately equal economic importance." [8]

Trade, however, is not merely between two countries. If Germany cannot find a large enough market for matches in England to pay for Germany's whole consumption of cloth, she might, for example, send matches to Portugal and let Portugal send wine to England. It can be seen that the entire world market is involved, not only for matches but for all commodities and for all countries. If Mill's conclusions, even on the basis of his own simple assumptions, are misleading, they are far more inadequate, Graham maintains, as generalizations applying to the real world.

Mill's two-country, two-commodity procedure, Graham points out, conceals the fact that comparative advantage in realistic situations varies according to the terms at which products are exchanged. For example, if the foreign demand from all sources for a certain article declines (or if the supply of it increases), so that this article trades for fewer foreign goods, a nation producing the article might find that it no longer had an advantage in its production. The nation might have been a marginal producer of the article, and because of the reduction in demand (or increase in supply), become a submarginal producer. On the other hand, an increase in the demand for a commodity (or a decrease in the supply) would tend to produce opposite results.

[8] "The Theory of International Values Re-examined," *loc. cit.*, p. 59.

Mill's illustrations, says Graham, give the impression that the terms of interchange are determined by reciprocal demand on the basis of a *fixed* comparative advantage situation for each country. A change in the terms of interchange, however, will tend to alter the comparative advantage situation of one or more countries. A slight change in these terms, which is reflected in a change in price, may make it profitable for a country to produce a commodity which it formerly only imported, or to export a commodity which it formerly produced only for home consumption, or to import a commodity which it formerly produced at home, and so on. Thus to reason about reciprocal demand and terms of interchange as if import and export schedules for the various countries were fixed is a mistake. Yet this, Graham maintains, is precisely what the classical writers did, on the basis of oversimplified assumptions, with the result that they implicitly assumed the very ratio of interchange they were trying to discover.

On the positive side, Graham shows how the terms of trade are actually established, and, under given assumptions, what the exact terms would be. His analysis gives a precision to the terms of trade which is lacking in the classical analysis, and also in that represented by Ohlin.

General Equilibrium Theory.—In contrast to the classical theory of international trade is what is commonly referred to as the "general equilibrium" theory. Widely accepted in recent years, this is an attempt to restate the theory of international trade in terms of modern value theory. It is essentially the application of domestic value theory to foreign trade—the remedying of an illogical distinction made by classical economics. The problem is attacked from the standpoint of demand and supply rather than by starting with cost of production and then building up to price. While the classical and general equilibrium approaches start at different ends, the theories as a whole and their conclusions are not as far apart as might at first appear. Much of the difference is a matter of emphasis.

Equilibrium reasoning is not new as an explanation of value, domestic and foreign, yet its widespread acceptance as applied

to foreign trade has been a recent and tardy development.[9] Bertil Ohlin, of Sweden, has done much to promote a wider understanding of equilibrium reasoning as applied to the international field. Ohlin's analysis is set forth in his work, *Interregional and International Trade,* published in 1933, and is a comprehensive statement of the equilibrium position. In the preface to this treatise, Ohlin declares that he has attempted to construct "a theory of international trade in harmony with the mutual-interdependence theory of pricing—the universally accepted price theory today—and thus independent of the classical labor theory of value." [10] The title of Ohlin's work emphasized the fact that the theory of international trade is to be developed in essentially the same way as the theory of trade between regions. This is in contrast to the classical outlook, which emphasized the differences between intranational and international trade.

Following orthodox equilibrium analysis, Ohlin begins by pointing out that regions and nations specialize and trade with one another for the same reasons that individuals specialize and trade. Certain persons are naturally best fitted for certain occupations. By temperament and abilities (native or acquired), one man becomes a gardener, another a teacher, a third a lawyer, and so on. The gardener would probably make a poor lawyer, and the lawyer might make a poor teacher; the gain from specialization, in any event, is clear. Even if every individual were exactly alike in ability and temperament, it would still pay to specialize. By so doing, each person would acquire a degree of skill not otherwise attainable, and would avoid the loss of time involved in shifting from one occupation to another.

Much the same reasoning can be applied to nations. One nation has a large amount of fertile land, no minerals, and a small population. Another has iron and coal mines, a large population, and little land. The former country would probably be well adapted to agriculture, the latter to manufacturing.

[9] Pioneer work in general equilibrium analysis was done by Leon Walras (1834-1910), Vilfredo Pareto, Knut Wicksell, Gustav Cassel, and Frank A. Fetter.

[10] Cambridge, Mass.: Harvard University Press, p. vii.

In either case, the fields of superiority depend upon the extent to which the different factors of production occur in each country. It is, of course, not the possession of absolutely superior facilities which is the significant and determining condition; it is, rather, a question of which facilities are relatively the best. In the words of Ohlin:

> Australia has more agricultural land, but less labor, capital, and mines than Great Britain; consequently Australia is better adapted to the production of goods which require great quantities of agricultural land, whereas Great Britain has an advantage in the production of goods requiring considerable quantities of other factors. If both countries produced their own total consumption, agricultural products would be very cheap in Australia, but manufactured articles relatively dear, whereas the reverse would be the case in Great Britain. . . .
>
> In brief, each region is best equipped to produce the goods which require large proportions of the factors relatively abundant there; it is, on the other hand, least fit to produce goods requiring large proportions of factors existing within its borders in small quantities or not at all.[11]

Having made these general observations, Ohlin proceeds to introduce money and prices. He first points out that it is impossible for one region or country to produce all commodities more cheaply than all other regions or countries. He illustrates this point as follows: Suppose there are two countries, A and B, each having a paper currency, and that at the prevailing exchange rate all prices in A are lower than the corresponding prices in B. In this case, people in B would buy goods from A, where low prices prevail, but no people in A would buy goods from B which has high prices. But with goods flowing in one direction only, that is, from A to B, the exchange rate could not remain stable. The currency of A would be much in demand in B, while the currency of B would not be at all in demand in A. At the same time, there would be no supply of A's currency in B, since no one in B would have the right to draw a draft on anyone in A. In this situation, importers in B would bid up the exchange rate on A until some prices in A were higher to persons in B than the corresponding prices in B, making it pos-

[11] *Op. cit.*, p. 12.

sible for goods to flow in both directions. Equilibrium would be attained when the exports of each country exactly paid for the imports.[12]

In only one situation, Ohlin shows, could the result be otherwise. This is where relative prices in the two countries are the same, in which case no trade at all would take place. To illustrate: suppose that in A three commodities—wheat, cotton, and lumber—are produced, and that the price of a given quantity of wheat is, say, twice that of a given quantity of cotton and one-third that of a given quantity of lumber. Suppose also that B produces the same commodities (of the same quality), and that the prices of these goods bear exactly the same relationship to one another as the prices in A. Finally, assume as in the preceding illustration that all prices in A are lower than the corresponding prices in B. This is, of course, an unstable situation. For a time, the three commodities would flow from A to B. The exchange rate on A would be bid up, as noted above, but when prices in A equaled those in B (allowing for cost of transportation) all movement of goods would cease, since neither country would have a price advantage over the other in any commodity, the prices being in the same relationship in both countries, and after the shift in price levels, the prices themselves being the same in both countries. Hence, for there to be trade between countries, relative prices in each must differ.

Having attributed the existence of trade to differences in relative prices between regions or countries, Ohlin next discusses the factors determining relative prices within a single region or country. Prices are determined, Ohlin declares, by "the demand for goods and the possibilities of producing them" —that is, by demand and supply. But what lies back of demand and supply? Demand, says Ohlin, is conditioned by two circumstances: (1) "the wants and desires of consumers," and (2) "the conditions of ownership of the factors of production, which affect individual incomes and demand." The latter refers to

[12] Under a gold standard, equilibrium would be attained by a slower process. The exchange rate on A could rise only to the gold-export point of B, after which gold would flow from B to A, raising prices and incomes in A and lowering them in B until an equal value of goods moved in both directions.

the distribution of purchasing power in the hands of consumers to back up the "wants and desires" referred to in (1). Supply, he declares, is also governed by two conditions: (1) "the supply of productive factors," such as natural resources, labor supply, etc., and (2) "the physical conditions of production," which are uniform throughout all countries. He writes:

> In each region, then we have a price mechanism, resting on these four basic elements, which determines simultaneously the prices of commodities and of industrial agents [factors of production]. The question is evidently under what conditions these elements have a relation to one another, such that relative commodity prices coincide in two isolated regions, in which case no trade can arise. When the relation between them is different, relative commodity prices are also different, and interregional [and international] trade will come into existence.[13]

Of these four factors governing demand and supply, Ohlin lays greatest stress on "the supply of productive factors," which he regards as chiefly responsible for relative prices in one country being different from those in other countries. He admits that it is theoretically possible for demand to offset, or more than offset, the distribution of productive factors in a region or country, so that, for example, a region with a large supply of a certain factor might find that factor in strong demand and thus relatively scarce. He points out, however, that such a situation is improbable:

> There is no reason why demand in a scantily populated region should turn especially to goods requiring much land and little labor, say wheat, and thus prevent rent from being lower, relatively to wages, than in a densely populated region, where, as people cannot after all do without food, land is necessarily scarce.[14]

In contrast to the classical writers, Ohlin devotes much space to a discussion of the effect on international trade of movements of the factors of production from one region or nation to another. He points out that "factor movements" tend to be an alternative to the movement of goods. When labor and capital

[13] *Op. cit.*, pp. 14-15.
[14] *Op. cit.*, p. 16.

move to areas where the reward for their services is higher, wages and interest tend to become equalized in the two regions. This has the effect of tending to equalize the prices of the goods produced by these factors in the two regions, which in turn tends to reduce the volume of goods traded. Thus factor movements, he declares, "act as a substitute for the movement of commodities." [15]

Another writer who has helped to develop the equilibrium approach is Gottfried von Haberler, whose *Theory of International Trade* was published in 1933. Like Ohlin, Haberler aims "to display the theory of international trade as a constituent part of the modern doctrine of economic equilibrium." Consequently, he rejects the classical labor theory of value. In this connection, he writes:

> This latter doctrine [the labor theory of value] holds good . . . if there is only one factor of production: homogeneous labor. But in reality any country has a great number of different factors of production—a whole range of different qualities of labor, of land and other natural resources, and of produced means of production, such as buildings, plant and equipment, and raw materials. It is technically impossible to measure all these diverse factors of production in terms of any one common unit of quantity; they certainly cannot all be resolved into simple unskilled labor.[16]

The "sole purpose" of the labor theory of value, Haberler declares, was "to determine the relative prices in each of the two countries [in the classical illustration]." [17] But since relative prices can be explained more adequately by general equilibrium theory, the labor theory, he says, is no longer needed.

In the preface to his book, Haberler expresses the conviction that an important task, as yet hardly more than begun, is the application of the theory of the business cycle and the theory of imperfect competition to the problems of international trade.[18]

[15] *Op. cit.*

[16] *The Theory of International Trade* (English ed.), p. 175.

[17] *Ibid.*

[18] A good statement of modern international-trade theory as well as a discussion of classical doctrine is found in Paul T. Ellsworth, *The International Economy* (New York: The Macmillan Co., 1950).

Comparison of the Two Theories.—By way of summary, according to the equilibrium theory, which now largely dominates the field, trade takes place between regions or countries primarily because of differences in productive facilities and conditions. These differences, in conjunction with variations in demand, lead to different commodity prices, or more precisely, to different commodity price relationships in the various countries. Because of different commodity price relationships, certain goods can be obtained more cheaply abroad than at home. Commodity price relationships are based largely on the price relationships of the factors of production. If the factors of production were free to move from country to country, their movement would tend to reduce price differences of the factors and of the commodities.

When trade takes place, that which is given automatically equals in value that which is received. The ratios at which goods trade, that is, the terms of trade, are an outgrowth of demand and supply forces, namely, of the extent and strength of demand on both sides, i.e., reciprocal demand. Demand is to be measured in terms of that which is offered, which is supply and is also buying power. That which is offered, i.e., the amounts and kinds of goods exported are related to consumers' choices and to the difficulties of production. If goods are hard to produce few will be produced unless desires for them or what they will buy are very strong.

Exchange rates between currencies reflect reciprocal demand, and tend to settle at a point where value equivalence is established between what is currently given and received. The quantities given and received tend to represent the terms of trade. An equilibrium rate of exchange is thus one that equilibrates, and in a nutshell this is about all that can be said.

The modern classical reasoning comes to practically these same conclusions, but arrives there by devious routes, making unreal assumptions and then making qualifications and adjustments so as to fit the facts. The equilibrium theory recognizes not only cost as a determinant of price, but price as in turn a determinant of cost, whereas the classical theory emphasized the former sequence of causation, namely, that of cost to price,

counting on free competition and demand and supply forces to bring prices into harmony with costs. Equilibrium theory says that this reasoning is incorrect in that demand is equally significant with supply, and also that free competition is an unreal assumption.

Classical theory recognizes that, particularly in international trade, free competition and perfect mobility of productive factors do not exist, and therefore in the international field emphasizes cost differences (and consequently price differences) as the driving force behind trade, identifying costs closely with prices. Equilibrium theory, on the other hand, emphasizes price differences, pointing out how prices are not absolute facts determined independently by themselves nor by costs, but are rather the result of many interacting influences including demand as well as supply, and demand not only for the article in question, but for an infinite number of goods and services which may be consumed instead.

It can be seen that the two theories are in many ways far apart, yet, from the standpoint of results and public policies to be pursued, come to similar conclusions. The modern classical theory would not deny the essentials of the equilibrating process, nor would the equilibrium theory pretend that cost analysis is of no significance.

Developments Since 1930.—The period since the middle of the 1930's has been one of special activity and development in the field of general economic theory. The depression and the sharp declines in employment, incomes, prices, and trade stimulated study of the theoretical aspects of these movements. The changes in thinking which took place included the field of international trade theory. The developments in this field, however, have been in the nature of refinements and additions rather than invalidation of major principles. The changes in theoretical thinking which have been generally accepted have been incorporated in the discussion of the preceding pages, so that no separate treatment of them will be given here apart from a brief word as to their general nature.

The changes in economic theory which took place in the years preceding the outbreak of war, especially following the

publication in 1936 by J. M. Keynes of his *The General Theory of Employment, Interest and Money,* centered around the subject of money, incomes, interest rates, and prices. In the international field the theoretical thinking affected particularly such matters as adjustments in the balance of payments, exchange rates, and prices.

The principal explanation of the means by which deficits or surpluses in the balance of payments were eliminated, or exports and imports increased or decreased to provide for capital flow, had long been what was known as the price-specie-flow mechanism. A deficit in the balance of payments, or pressure on a country's exchange rates because of an outflow of capital, would lead to the loss of gold and to declining prices, which would attract increased purchases on the part of foreigners. These larger exports would tend to restore equilibrium. These developments within a country were aided by the receipt of gold in foreign countries followed by higher prices there, and as a result reduced sales to the deficit country. In the absence of the gold standard, it was noted, exchange rate movements would alter price relationships and thereby increase or decrease exports and imports in the direction of equilibrium.

The newer theory did not deny the validity of the above reasoning but pointed out that the adjustments described were slow, and that ordinarily the larger share of adjustment was accounted for by movements of incomes and employment. An expansion in exports which caused a surplus in the balance of payments, brought about, it was noted, increased employment and incomes in the export industries. The increase in employment and incomes would spread throughout the entire economy and cause greater imports, thereby promoting a balance. Recognition and greater understanding of the important role of income, not only in the domestic economic field but also in that of international trade, was a significant development. This subject is discussed in Chapters 8 and 9.

Shortly after the first World War most countries suffered from inflation and rapidly rising prices. Exchange rates tended to reflect the internal depreciation, and the purchasing power parity theory, developed earlier, was widely accepted as an ade-

quate explanation of exchange rates and their movements. This theory taught that exchange rates represented the ratios between the internal purchasing powers of currencies, and that movements in exchange rates were in response to movements, actual or anticipated, in internal purchasing powers. If a currency bought less, its exchange rate value was accordingly less. Subsequent analysis, however, brought out the fact that the internal purchasing power of a currency is only one element in the demand and supply for such currency, and that other factors such as a change in production or other real changes in demand and supply, might also affect exchange rates without any movement in relative prices having taken place. This subject is discussed in Chapters 6 and 16.

The more recent theoretical analysis also dealt with such matters as the elasticities of demand and supply of exports and of imports, and substitutions of domestic for international goods and vice versa. The effects of elasticities upon exchange rates and exchange stability were examined in connection with the practical problem confronting governments of adjusting rates toward an equilibrium level. It was pointed out that small balance of payments deficits may cause drastic changes in exchange rates, or stating the matter another way, that drastic rate changes may be required to bring equilibrium in the balance of payments. Controversy existed over the extent to which conditions of this kind actually existed, especially in view of the political unpopularity of exchange rate adjustments. A theory which can support failure to make a rate adjustment indicated on economic grounds has practical convenience. A further question was the extent to which a country which depreciates its exchange rates will thereby obtain markets from competitors and expand its exports at their expense.

Attention was also given to the effects of international trade upon the distribution of incomes and the factors of production, as well as to the long standing subject of the gains from trade and how they are divided. The writings of Eli F. Heckscher in the field of comparative advantage and the effects of trade upon the factors of production and distribution had appeared in 1919, but since they were in Swedish became known only slowly to

the English-speaking world. This subject was discussed in Chapter 10. On the subject of the gains from trade Paul Samuelson showed precisely that if countries trade with each other, each country is able to obtain more of every commodity while performing less of every productive service. Trade thus brings a gain to all countries. Frank Graham's criticism of the classical two-country, two-commodity approach has already been discussed. He showed how, with several countries and many commodities involved, the substitution of the goods and services of one country for those of another country tend to promote greater stability in exchange rates and the terms of trade than was indicated by the classical analysis.

The major development of recent times in the field of international trade theory, however, has been the widespread acceptance of the general equilibrium theory as applied to international trade as well as to domestic trade, and the careful analysis of problems arising in connection with such application. This theory was long applied to domestic economics, but its necessary extension to the international field was not widely recognized until the latter part of the 1930's. Since this subject has been discussed in Chapter 11 it will not be considered here.

Chapter 16

HISTORY OF INTERNATIONAL MONETARY THEORY

The theory of money and the theory of international trade developed side by side, but to a considerable extent each independently of the other. Economists historically regarded the theory of value and trade, and the monetary phases of economic theory as largely separate and distinct. The theory of money was not considered an integral part of general economic theory, but was tacked on as a sort of appendage. Here was the theory of value, price, distribution, and such matters, while over there was the theory of money and the foreign exchanges. Only in recent years have monetary theory and other phases of economic theory been merged into a single whole and treated as parts of a unified general theory of economics.

Beginnings of International Monetary Theory.[1]—Rudiments of the quantity theory of money go back to ancient times, but most early statements are little more than casual recognition of a general relationship between the quantity of money and the value of the unit of money. For example, Xenophon in the fourth century B.C. noted that if gold appeared in great quantity, it became much less valuable. Aristotle (384-322 B.C.) also recognized the importance of the quantity of money in the determination of its value. In his *Politics,* Aristotle attempted to show how barter, and later trade with money, originated. He declared that

> . . . barter, in general, had its original beginning in nature, some men having a surplus, others too little of what was necessary for them.

[1] For discussion regarding the evolution of money and the various forms of early money, see pages 13-14.

. . . It is plain that barter could have no place in the first, that is to say, in family society; but must have begun when the number of those who composed the community was enlarged: for the first of these had all things in common; but when they came to be separated they were obliged to exchange with each other many different things which both parties wanted. Which custom of barter is still preserved amongst many barbarous nations, who procure one necessary with another, but never sell anything; as giving and receiving wine for corn and the like.[2]

The inconveniences of barter, according to Aristotle, led to the invention of money:

But this barter introduced the use of money, as might be expected; for a convenient place from whence to import what you wanted, or to export what you had a surplus of, being often at a great distance, money necessarily made its way into commerce; for it is not everything which is naturally most useful that is easiest of carriage; for which reason they invented something to exchange with each other which they should mutually give and take, that being really valuable itself, should have the additional advantage of being of easy conveyance, for the purposes of life, as iron and silver, or anything else of the same nature: and this at first passed in value simply according to its weight or size; but in process of time it had a certain stamp, to save the trouble of weighing, which stamp expressed its value.[3]

One of the most remarkable of the early statements on money was that of Julius Paulus, the prolific Roman jurisconsul who died, or rather was put to death, in A.D. 230. He said, "That material which has been struck with the public stamp (as coin), has use and value, not so much from its substance as from its quantity." [4] Here is a clear-cut quantity explanation of the value of money. Numerous statements emphasizing the importance of the quantity of money in the determination of its value can be found through literature from Greek and Roman times on down to the more careful monetary studies of the last century or two.

[2] Book I, Ch. IX.
[3] *Ibid.*, Book I, Ch. IX.
[4] Julius Paulus, *Pandectus*, II, Book XVIII, 147; quoted by E. W. Kemmerer, *Money and Prices* (New York: Henry Holt & Co., Inc., 1909).

Important contributions in the field of monetary theory and the relation of money to trade were made during the sixteenth to eighteenth centuries, more or less independently of the rise and decline of mercantilist doctrine. As already noted, several of the mercantilists had an understanding of the effect of changes in the quantity of money upon commodity prices.[5] Petty (1623-1687) pointed out that raising the denominations of coins but leaving the bullion content unchanged would merely increase the number of units of money that could be made from a given quantity of bullion, and so raise prices, but would not add to the total real value of a country's money. Petty, however, had no clear conception of the quantity theory of money. Inasmuch as the mercantilists gave considerable attention to foreign trade, they had some knowledge of the relation of the flow of specie to the balance of trade, namely, that a large outward movement of goods tended to cause an inward movement of specie. Although they had a certain grasp of the quantity theory, nevertheless, they were not particularly concerned with the general bearing of this theory upon their main doctrine that a large supply of specie was especially desirable.

The French economist, Jean Bodin (1530-1596), made noteworthy observations on money. The period during which Bodin lived saw an enormous flow of the precious metals into Europe from the recently discovered New World. As a result of this inflow of gold and silver, commodity prices increased greatly, to about three times their former level. Bodin was apparently the first writer to connect this rise in prices with its underlying cause. He showed that popular explanations of the rise in prices were entirely inadequate, and that the real cause was to be found in the enlarged supplies of money. His reasoning, though elementary as viewed today, was a step forward and had a wide influence on continental and British thinking.

John Locke (1632-1704) and David Hume (1711-1776), both of whom are perhaps more widely known as philosophers than as economic thinkers, contributed a great deal to monetary

[5] Viner discusses this in his *Studies in the Theory of International Trade*, pp. 40-45. He points out that Malynes, Mun, Sir Robert Cotton, Henry Robinson, and other early British writers adhered to a simple quantity theory of money.

theory. John Locke is generally credited with being the first to present a definite and careful analysis of the theory of money. Denying that money has "intrinsic" value, Locke declared that "the *value of money* in respect of those [other goods] . . . depends only on the plenty or scarcity of money in proportion to the plenty or scarcity of those things." [6] Locke further recognized that the amount of money required to keep the value of money at a particular level "depends not barely [merely] on the quantity of money but on the quickness of its circulation." [7]

Locke, however, overlooked significant international implications of his doctrine. While he perceived that a country, by losing money, would tend to have lower prices, he failed to recognize that this situation would tend automatically to correct itself, the lower prices stimulating sales abroad and discouraging purchases there, thus tending to check the outflow of money.

David Hume, by analyzing the relationship of price levels in different countries and the functioning of the quantity theory of money internationally, pointed out what Locke had apparently failed to grasp, namely, that low prices in one country would attract money from other countries, thereby tending to raise these prices until they were in harmony or equilibrium with prices throughout the world. His words to this effect are:

> Suppose four-fifths of all the money in Great Britain to be annihilated in one night, . . . what would be the consequence? Must not the price of all labor and commodities sink in proportion . . .? What nation could then dispute with us in any foreign market, or pretend to navigate or to sell manufactures at the same price, which to us would afford sufficient profit? In how little time, therefore, must this bring back the money which we had lost, and raise us to the level of all the neighboring nations? Where, after we have arrived, we immediately lose the advantage of the cheapness of labor and commodities; and the farther flowing in of money is stopped by our fullness and repletion.[8]

[6] Locke, *Consequences of the Lowering of Interest* (1691), as quoted in James W. Angell, *The Theory of International Prices* (Cambridge, Mass.: Harvard University Press, 1926).

[7] Locke, *ibid.*, as quoted in Angell, *ibid.*, p. 19.

[8] From Hume's essay, "Of the Balance of Trade," in his *Political Discourses* (1752), as quoted in A. E. Monroe, *Early American Thought* (Cambridge, Mass.: Harvard University Press, 1924), p. 325.

This analysis of Hume, now often referred to as the "price-specie-flow analysis," was taken over by the English classical theorists. According to this doctrine, prices in all countries are related to each other, so that price movements in one country tend to affect prices in other countries as well. In any particular country, the level of prices is governed essentially by the quantity of money circulating there. If, however, prices in one country are lower than the equilibrium level, exports from that country will as a result tend to be increased to the extent that gold will flow into such country in payment for the exports. This inflow of money will tend to raise prices and incomes there until equilibrium is restored. The opposite situation will tend to occur where prices in a country are higher than the equilibrium level.

Hume also pointed out that the narrow movements of exchange rates within the gold-import and gold-export points tended to check a "wrong balance of trade." "When we import more goods than we export," he wrote, "the exchange turns against us, and this becomes a new encouragement to export; as much as the charge of carriage and insurance of the money which becomes due would amount to. For the exchange can never rise but a little higher than that sum." [9] This statement, it will be noted, refers to physical goods and fails to include invisible items. It was, however, another step forward, and reveals that Hume had some practical knowledge of foreign-exchange transactions.

Montesquieu in 1748, in *L'Esprit des lois,* presented a quantity theory analysis. He said:

> An increase in the quantity of gold and silver is then advantageous when one regards the metals as articles of merchandise, but not when one regards them as tokens, because their value as tokens, being largely dependent on their scarcity, is decreased by abundance. . . .
>
> If, since the discovery of the Indies, gold and silver in Europe have increased in the ratio of one to twenty, prices of commodities must have risen in the ratio of one to twenty. But if, on the other hand, the amount of commodities has increased in the ratio of one to two, it must be that prices have on the one side risen in the ratio of one to

[9] Hume, *op. cit.,* as quoted in Monroe, *op. cit.,* p. 326.

twenty, and that, on the other, they have fallen in the ratio of one to two, so that they actually stand, in consequence, at the ratio of only one to ten.[10]

Classical Monetary Theory.—Classical economists, as indicated above, were inclined to regard monetary questions as of secondary importance and as separate from the main body of economic theory. They held that economic phenomena are best understood by centering attention upon goods and services, which are the end of economic activity, rather than upon money, which they alleged, often conceals basic economic relationships.

By the time of Adam Smith, whose *Wealth of Nations* appeared in 1776, the main outlines of the quantity theory of money together with the self-regulating mechanism of international price levels, were fairly well developed. Smith accepted these theoretical foundations and did little, if anything, to refine them. In fact, in the *Wealth of Nations* he is less clear than Hume on the distribution of specie and on international price level relationships. His great achievement lay in a demonstration of the fallacies of mercantilism, and in setting forth the case for international specialization and free trade.[11]

Although the classical economists dealt with money separately and tended to subordinate its importance, they by no means neglected the general theory of money. Ricardo is especially noted for his grasp of monetary matters. His understanding of the subject was particularly evident in the long controversy in England over currency and exchange movements during the Napoleonic wars. In this so-called "bullion controversy," the issue was essentially whether or not, after specie payments were suspended by England in 1797, the rise in commodity prices, the fall in exchange rates, and the premium on bullion or

[10] Quoted by J. Laurence Laughlin, *The Principles of Money* (New York: Chas. Scribner's Sons, 1916), p. 230.

[11] Viner points out that although Smith in an earlier writing summarized approvingly Hume's price-specie-flow analysis, in the *Wealth of Nations* he makes no reference to this, but on the contrary reverts to the then obsolete explanation of specie distribution in terms of the requirements of a country, that if a country has too much money the money seeks profitable employment abroad. Viner, *op. cit.*, p. 87.

so-called high price of bullion, represented currency depreciation and an excessive issue of money. The "bullionists," led by Ricardo, held that the rise in prices, low exchange rates, and the premium on bullion were merely evidence of depreciation of the currency, which in turn was the result of overissue. The "anti-bullionists" denied this, and tried to maintain that the currency was not redundant or depreciated, but that the trouble lay with bullion itself. The question as we view it today seems, in its economic aspects at least, simple, and the trouble obvious, as it did no doubt to most of the economists of that period. In this controversy, Ricardo's forceful presentation of monetary doctrine and his clear analysis of the issues influenced greatly monetary thinking for years to come.

Ricardo, in stating his doctrine of comparative costs (real costs) in terms of money and prices, maintained that in the long run the movement of goods in international trade is the same under a monetary economy as it would be under a system of barter. Monetary costs, according to Ricardo, are merely a reflection of real costs, i.e., labor costs. Although actual trade takes place in terms of money, this fact, he declared, does not alter the basic situation. To substantiate this contention, Ricardo made use of Hume's monetary analysis, according to which gold settles a deficit in the balance of trade and alters price level relationships. Referring to his original illustration, Ricardo showed what would happen if England, as a result of the discovery of a new process for making wine, found it to her advantage to produce her own wine rather than to import it. In this event, said Ricardo, Portugal would continue for a time to import cloth from England, since the price of cloth would remain unchanged. Since, however, Portugal would no longer be able to pay for the cloth with her wine, she would be forced to export gold to England, which would raise prices and money costs in England and lower them in Portugal until it would no longer pay Portugal to import cloth. If the improvement in making wine in England were very great, it might be advantageous for the two countries to exchange their specialties, England producing wine and Portugal cloth. In this event, the

changed situation would result in a new distribution of the precious metals, and trade would again proceed as if on a barter basis.[12]

Nassau William Senior (1790-1864) gave considerable attention to money. He included credit in the monetary supply and therefore in the factors affecting prices. A greater use of book credits, he pointed out, would influence prices in the same manner as an issue of paper money. An expansion of credit would thus tend to raise prices.

John Stuart Mill, writing about the middle of the nineteenth century, followed the general reasoning of Ricardo. He agreed with Ricardo that in the long run the terms and direction of international trade would be the same under a monetary economy as under a system of barter. Mill did not add greatly to international monetary theory, but he modified and refined the quantity theory, developing the role of "rapidity of circulation." He believed, however, that under most circumstances the velocity of circulation and the volume of trade were relatively unimportant factors, and that it was the quantity of money that was of special consequence. Like Senior, Mill recognized that credit should be considered as no different from money in its effect upon prices.[13]

The fact that a given amount of gold can support a much larger volume of bank credit, thus making international price adjustments more rapid than would otherwise be possible, was appreciated by many of the nineteenth-century economists. It was shown that where credit is used as money, prices tend to fall more rapidly when gold is leaving a country, and to rise more

[12] Certain critics of the classical school, such as Bertrand Nogaro of France, have not shared the conviction that money is of but secondary importance in international trade theory. They have criticized classical writers for failing to devote adequate attention to the international aspects of money, declaring that the Ricardian monetary analysis is greatly oversimplified, and have maintained that the money factor, in the long run as well as in the short, can affect the direction and character of international trade.

[13] Mill wrote: "Credit which is used to purchase commodities affects prices in the same manner as money. Money and credit are thus exactly on a par in their effect on prices; and whether we choose to class bank notes with the one or the other is in this respect entirely immaterial" (*Principles of Political Economy*, Book III, chap. xii).

rapidly when gold is entering a country, than is possible under a system where gold is not used to support bank credit.

Currency understanding was promoted by the active discussions in England prior to revision of the statutes relative to the Bank of England by the Bank Charter Act of 1844. At that time it had come to be realized in economic circles that bank discount policies and the expansion and contraction of bank notes affected the price level and were therefore factors in exchange rates, specie movements, and also in fluctuations in business conditions. The recurring periods of prosperity and depression were recognized as being related to monetary expansion and contraction. The proper method of dealing with this situation, however, was a matter of controversy.

The so-called Currency School argued that if the aggregate volume of currency were allowed to fluctuate exactly as it would if it consisted entirely of specie, all would be well. This group did not consider deposits as money and confined their definition of money to bank notes and coin. They therefore believed that in order to accomplish their objective of limiting monetary expansion to that of specie, Bank of England notes should not be allowed to increase unless backed 100% by specie. This would cause the volume of money to conform to the specie volume. They also had implicit confidence in the satisfactory functioning of the automatic gold standard. Their line of reasoning, known as the Currency Principle, it will be noted, was based upon this assumption.

The opposing group, known as the Banking School, differed considerably among themselves, but in general emphasized the importance of deposits in the monetary structure. They therefore attached special significance to the discount and lending policies of banks and the effect upon deposits. The volume of notes, it was said, adjusted itself to the needs of merchants, whereas the volume of deposits fluctuated with an expansion or contraction of loans. It was further argued that if the expansion of deposits was a result of loans to finance additional business and production of commodities, no harm would come. Therefore, banks might properly be allowed to maintain partial reserves, but they should limit their loans to short-term com-

mercial transactions.[14] The Banking School, like the Currency School, did not question the satisfactory nature of the automatic gold standard. Both groups failed to realize the need for supervision over currency and banking matters.[15]

Both schools of thought recognized that disequilibrium between the domestic price level and foreign price levels would tend to cause the movement of gold. The Currency School felt that this was the only cause of gold movements, whereas the Banking School pointed out that fear and other conditions might lead to an alteration of exchange rates and to gold movements. The Banking School also pointed out that a loss of gold would not immediately cause a contraction in the volume of money since exports of gold would come largely out of bank reserves. Only as banks, with lowered reserves, raised interest rates and discouraged borrowing would the currency volume tend to contract.

Among the prominent writers and participants in the controversy of this period were Thomas Tooke and John Fullarton, who stand out for their clear thinking and understanding of the essential issues. Tooke wrote extensively on financial questions and is well known, with W. Newmarket, for their six-volume work, *A History of Prices and of the State of the Circulation During the Years from 1793 to 1856*. Fullarton urged that all gold reserves be held by the Bank of England and that the Bank be given wide discretion over the reserve which it maintained.

International Monetary Theory, 1850-1930.—Following the discovery of America and the large stock of mined and unmined precious metals there, the European supplies and world production of gold increased greatly, particularly after about 1680. The spectacular increase in gold production, however, came much later, beginning shortly before 1850. It is still continuing.

[14] This theory of the automatic and inherent soundness of short-term self-liquidating paper is the same as that embodied in the Federal Reserve Act of 1913.

[15] The Act of 1844 which rechartered the Bank of England embodied the philosophy of the Currency School, tying rigidly the volume of notes to the volume of specie. Since the use of deposits was growing, whereas that of bank notes was becoming less important, England, nevertheless, had in fact an elastic currency.

This great increase followed the gold discoveries in California (1848) and Australia (1851), and later in Alaska (1880)[16] and South Africa (1884). It was also the result of the invention of the cyanide process which came into use late in the century and which made possible the extraction of gold from poorer grade ores. This process greatly expanded the production of the South African mines where the accumulations of discarded ores were reworked. In the decade ending in 1840 world gold production averaged about 652,000 ounces per year, while by 1854 it had climbed to 7,102,000 ounces and by 1915 to 22,678,000 ounces.[17] In 1941, after the price of gold had been raised by the United States (1933) and others, gold production amounted to about 42,000,000 ounces.

This period of unusually large gold production saw the adoption of the gold standard by most of the leading countries of the world which did not already have it. Largely as a result of this expansion in the demand for gold, the commodity price level, in terms of gold, was declining from about 1873 to 1896. It then rose, accompanying new increases in gold production, to 1914 when paper currency and deposit inflation in most countries carried the rise very much further. Since then gold has been used largely for purposes of international trade and for hoarding as discussed in Chapter 24.

During these decades of currency change and price level upheaval, it is logical that monetary thought should be concerned particularly with forces affecting the value of money. Thus John E. Cairnes and W. Stanley Jevons discussed at length the effects of the new gold upon prices and its distribution throughout the world. Controversy raged over the validity of the Quantity Theory, and over the relation of the value of gold to the use of gold as money. The Quantity Theory emphasized the quantity of monetary units, regardless of the commodity value of the material of which the money was made. This view was vigorously denied by those who declared that the value of money rested upon the usefulness of its commodity content, and in the case of fiduciary money upon its redemption in

[16] The Klondike rush began in 1896.
[17] Cf. Annual Report of the Director of the Mint.

specie, present or prospective. Inconvertible money was held to be valuable because of confidence in ultimate redemption.[18]

The German economist, G. F. Knapp, in his *State Theory of Money* argued that money was a creature of law, and that the value of money was based on the fact that the state secured the validity of money. He overlooked the fact that governmental regulations were also a means of limiting the quantity of money.

Knut Wicksell, shortly before the turn of the century, pointed out the difference between what he called the natural rate of interest and the market rate of interest. An increase in the supply of money, he said, tended to lower interest rates just as did an increase in the supply of savings available for lending. The natural rate was that which equated savings and the demand for loanable funds, while the market rate was affected by the monetary supply of credit. Divergence of the market rate from the natural rate caused what he called a cumulative process, involving inflation or deflation and leading to economic disturbances. When the market rate is below the natural rate, he said, prices will rise.

In the early years of the twentieth century, interest in the theory of money was stimulated by the studies of several American writers, notably Irving Fisher and E. W. Kemmerer. Kemmerer's *Money and Prices* presented a strong case for the Quantity Theory and undertook a statistical verification of the theory in terms of his algebraic equation. A few years later appeared Fisher's *The Purchasing Power of Money* (1911), in which Fisher introduced his well-known equation of exchange, referred to in a previous chapter.[19] The first algebraic statement of the equation of exchange was made by the famous astronomer and economist, Simon Newcomb, a clear thinker in the field of currency, in his book, *Principles of Political Economy,* which appeared in 1885. Irving Fisher recognizes his indebtedness to Simon Newcomb with respect to the equation of exchange. Fisher, Kemmerer, and later Carl Snyder,

[18] Some of the principal participants in the currency discussions of this period were W. Stanley Jevons, Francis A. Walker, J. S. Nicholson, Alfred Marshall, Leon Walras, Simon Newcomb, Friedrich Wieser, Knut Wicksell, G. F. Knapp, and J. Laurence Laughlin.

[19] Chapter 6, "Money, Prices, and the Rate of Exchange."

G. F. Warren, F. A. Pearson, and others made statistical investigations regarding the Quantity Theory. Snyder showed that over the years, when the monetary supply expanded faster than the growth of physical production, a rise in prices resulted, and vice versa. He urged that the monetary supply be so regulated that its rate of growth correspond to that of business.

During the first World War and the postwar period, disordered currency systems, drastic price rises, and widely fluctuating exchange rates commanded the attention of people in all countries. One of the most significant theoretical contributions of this period was the purchasing power parity doctrine, already referred to, advanced in 1916 by Gustav Cassel of Sweden.[20] Referring particularly to inconvertible monetary systems, Cassel reasoned that the exchange rate of one country on another would tend to remain the same so long as the price levels in the two countries did not change, or so long as the price levels rose or fell together and at the same rate. If, however, only one of the price levels was changing, or if both price levels were changing but at different rates, the exchange rate between them, according to Cassel, would tend to move in such a way as to reflect the new value relationship between the two currency units. In Cassel's own words:

> Given a normal freedom of trade between two countries, A and B, a rate of exchange will establish itself between them and this rate will, smaller fluctuations apart, remain unaltered as long as no alterations in the purchasing power of either currency is made and no special hindrances are imposed upon the trade. But as soon as an inflation takes place in the money of A, and the purchasing power of this money is, therefore, diminished, the value of the A-money in B must necessarily be reduced in the same proportion. . . . Hence the following rule: when two currencies have been inflated, the new normal rate of exchange will be equal to the old rate multiplied by the quotient between the degrees of inflation of both countries. There will, of course, always be fluctuations from this new normal rate, and in a period of

[20] This theory is discussed at greater length in Chapter 6. Cassel revived rather than originated the purchasing power parity doctrine. According to Professor Angell (*op. cit.*, p. 52), the doctrine was first stated in clear-cut form by John Wheatley in 1803. See also Frank Whitson Fetter, "The Life and Writings of John Wheatley," *Journal of Political Economy*, June, 1942.

transition these fluctuations are apt to be rather wide. But the rate calculated in the way indicated must be regarded as the new parity between the currencies. This parity may be called the *purchasing power parity,* as it is determined by the quotients of the purchasing powers of the different currencies.[21]

The doctrine as originally stated by Cassel overlooked the fact that trade between countries may change as a result of various factors that are entirely apart from price level movements. An altered trade situation means a change in the demand and supply of bills, and consequently a different rate of exchange. In other words, a change in reciprocal demand may mean a change in the equilibrium rate of exchange. Furthermore, capital movements may affect exchange rates without any change in price level relationships. The theory also failed to take account of the fact that the price level of domestic goods may change markedly without seriously affecting foreign trade and exchange rates.[22] Cassel later modified his statement to allow for these deficiencies.

In spite of its theoretical limitations, which Cassel recognized, the purchasing power parity doctrine was of practical value at a time when even well-informed statesmen were unaware of the close connection between inflationary policies and movements in exchange rates. Cassel's theory emphasized that internal depreciation was at that particular time the most important factor in the depreciation of the foreign exchanges.

International Monetary Theory Since 1930.—The unprecedented depression of the 1930's and the drastic declines in prices, incomes, employment, and output focused attention upon the theory of money and the relation of monetary matters to the disturbing movements that were taking place in most countries, particularly in the United States. Prior to that time economists

[21] Gustav Cassel, "Memorandum on the World's Monetary Problems," International Financial Conference, Brussels, 1920, in *Documents of the Conference,* V, 44-45.

[22] If domestic goods fall in price, they may become cheap enough to compete in the foreign market. But where this is the case, they cease to be domestic goods, so that the above statement—that the price level of domestic goods may greatly change without affecting exchange rates—remains valid.

had been concerned largely with factors determining the quantity or supply of money and the effect of quantity changes upon the level of prices. It had been generally assumed that newly created money did not long remain idle, and that an increase in the quantity of money was accompanied promptly by an increase in spending and by a rise in prices, unless the volume of production or "trade" increased proportionally or unless a change in the velocity of circulation took place. The importance of changes in the velocity of money was not overlooked, but it was believed that velocity was fairly stable as determined by public habits and convenience, and that changes in velocity were not extensive except under special circumstances as when the public feared suspension of specie payments or an outbreak of war. These assumptions accorded fairly closely with experience up to that time. Monetary theory had therefore succeeded in explaining the principal price level movements, which was considered its principal task. Its task was also considered to be to discover effective means of preventing or limiting price level movements, which were recognized as altering the relations between debtors and creditors and also altering the real incomes of fixed income recipients.

During the 1930's interest was shifted from a study of changes in the supply of money and causes thereof to an analysis of the factors which determine the rate of spending of money, and to the consequences of changes in this rate, especially the effects on the national income. Attention was centered on the relation of spending or not spending, as well as to the nature and direction of the spending, to income, employment, and output. Monetary theory and business cycle theory tended to merge, and became the special concern of economists in all countries, particularly in the United States and the United Kingdom.

In his *A Treatise on Money,* which appeared in 1930, John Maynard Keynes departed from customary treatment when he approached monetary theory not from the familiar quantity standpoint, although he recognized quantity as of fundamental significance, but from that of emphasis on saving and investment and the relation of these factors to income. The publica-

tion of Keynes' *General Theory*[23] in 1936 offered a revolutionary approach to general economic theory and stimulated a re-examination of the entire field, resulting not only in a revision of certain aspects of theoretical thinking, with consequent effects on public policy, but also in the integration of monetary theory with general economic theory.

It is not possible to discuss Keynes' theories in detail here, but it may be noted that he was concerned especially with the interrelations of employment, money, and investment. He argued that in an advanced economy, such as prevails in Great Britain and the United States, the rate of return on capital is too low to attract and maintain new investment at a level sufficient to provide full employment of workers and resources. Savings, he said, tend to outrun the utilization of these savings for investment purposes. The result of the excess of savings over investment is unemployment and underutilization of a country's productive resources. Governments should, he therefore maintained, in order to expand employment, income, and output, meet this deficiency through public works and governmental undertakings. Keynes' reasoning was an important factor in the United States government's spending program undertaken during the 1930's to relieve unemployment.

Keynes emphasized the importance of the propensity of consumers to consume and to invest their incomes. The public's desire to hold a certain amount of their resources in the form of cash balances, whether for the purpose of apportioning wages over the expenditures of the coming week or for a variety of other reasons, he referred to as liquidity preference, and pointed out some of the consequences which result from changes in the amount of cash balances which people or businesses hold. Interest rates, he said, were the result of the quantity of money and of liquidity preference, the larger the amount of money and the lower the liquidity preference the lower the rate of interest. The level of investment was the result of the height of the interest rate and the marginal efficiency of capital, a low interest rate and a high marginal efficiency of capital encouraging in-

[23] J. M. Keynes, *The General Theory of Employment, Interest and Money* (London, 1936).

vestment. Income, output, and employment were determined by the level of investment and the marginal propensity to consume. A high marginal propensity to consume and a high level of investment would result in a high level of income, output, and employment. He believed that the marginal propensity to consume was fairly constant and that the major variable which caused most of the trouble was the level of investment.

Other English writers who, along with Keynes, early followed a different approach to the theory of money were particularly A. C. Pigou, R. G. Hawtrey, and D. H. Robertson. They emphasized the demand for money, in contrast to the supply aspects of the problem, as indicated by the cash balances which people hold, the "unspent margin" as Hawtrey calls it. This Cambridge or cash balance approach, as it is sometimes known, draws attention to the desires and needs of people to hold money rather than to spend it, as noted above in the comments regarding Keynes. This approach relates the theory of money more closely to the theory of demand, of value, and to general theory since it stresses the fact that people are constantly comparing the importance to them, and making decisions at the margin of indifference, with respect to the goods which money could buy or the investments they could make, and the importance of holding the money as liquid cash.

In the well-known Irving Fisher equation, $MV = PT$, a change in cash balances would be reflected in a change in V or V^1, representing the velocities of money and of deposits respectively, an increase in such balances resulting in a reduction in V or V^1. The Cambridge or cash balance equation is usually written, $M = kPT$, in which M refers to the quantity of money, k the reciprocal of the velocity or $1/V$, P prices, and T the total value of money transactions. It will be observed that if the terms are defined as in the Fisher equation the cash balance equation is essentially the same as the Fisher equation. However, the symbols in the cash balance equation are interpreted somewhat differently, namely k is defined so as to apply only to money received as income, and refers to the relation of the public's cash balances to their total incomes. The quantity PT thus refers to the value of total income transactions, that is the

total value of current output, rather than to the total value of all monetary transactions. The emphasis is thus shifted from an analysis that is based on quantity of money, to an analysis that concerns itself primarily with income transactions, which are, of course, only a portion of total transactions. From the standpoint of understanding the business cycle, and in view of the availability of statistics on national incomes this approach has been significant. It has been possible to measure rather accurately the income or circular velocity of money and changes therein.

The attention which has been given the income approach has led to dissent over what is considered inadequate attention to the quantity and total monetary transactions approach. Thus Marget in his *Theory of Prices*[24] urges the advantages of a broader analysis based on the quantity equation, pointing out the incompleteness of a study which does not include all types of monetary transactions and which is confined to incomes.

Among the economists who have written on the relation of money to the business cycle mention should be made of F. A. Hayek. In his *Monetary Theory and the Trade Cycle*,[25] he developed the theory that "forced savings" (resulting from the decline in real values suffered by holders of money when prices rise) lead to excessive expansion of the capital goods industries and to economic disturbances. He proposed a system of so-called neutral money, wherein the aim would be to have money play a purely passive role.

The experience of the 1930's and the developments of those years in monetary theory affected fiscal, monetary, and central bank policies. At the time of the adoption of the Federal Reserve Act in 1913 monetary theory emphasized the importance of the total quantity or supply of money, and the relation of changes in quantity to ability to maintain free redemption in gold and fixed exchange rates. In order that the money be "sound" it was thought that regulation of monetary expansion and contraction should be largely automatic, and that central bank authorities should be guided in credit policies by the state

[24] Arthur W. Marget. New York: Prentice-Hall, 1938 and 1942.
[25] New York: Harcourt, Brace & Co., 1932.

of the gold reserve, which was regarded as practically the single criterion. If gold was leaving the country the bank should raise discount rates and tighten credit, and vice versa, the principal objective being maintenance of gold redemption and fixed exchange rates.

So long as a currency was freely redeemable in gold and the export and import of gold were not interfered with, price level movements did not cause much concern. It was during the 1920's that price level stabilization became a matter of special discussion (but not recognized officially as an objective), and during the 1930's that the aim of price level stabilization was expanded into the aim of income and employment stabilization (or steady growth). It was also during the 1930's that the difficulties of reconciling internal economic stabilization with free gold payments and fixed exchange rates under all conditions became apparent.

The accepted doctrine at the time of the Federal Reserve Act regarding bank loan and discount policy was that fluctuations in the volume of deposits, resulting from bank loans, should be made to coincide with those of the volume of business or "trade," insofar as this was possible within the limits set by the gold reserve. It was thought that close correspondence between the supply of money and the volume of business would be accomplished if banks confined their lending to loans which were to finance an actual expansion of business, and which were short term and self-liquidating. Deposit expansion and contraction would thus accompany business expansion and contraction. The Federal Reserve Act embodied these principles and conformed to the accepted monetary and central banking thinking of that time as it had developed from the discussions of the previous one hundred years.

The depression showed that the procedures intended to provide an adjustment of the supply of money to business were inadequate. Even though the central bank confined its loans to those of a short-term, self-liquidating nature, the banking system as a whole did not do so. Furthermore, there was nothing to prevent businesses which formerly had not been financed by bank borrowing from being so financed. An expansion of

loans therefore took place during the 1920's with a resulting increase in the supply of money relative to the growth of production and business.

As a result of the inflationary boom and subsequent deflation and economic collapse, various proposals were brought forward designed to stabilize the relation of the supply of money to the volume of production. These included the 100 per cent money proposal of Irving Fisher according to which banks would be required to maintain a 100 per cent cash reserve behind deposits and could thus not expand or contract deposits by lending operations. Another proposal was the commodity reserve plan of Benjamin Graham which would permit the unlimited monetization of certain basic and staple commodities, and, conversely, the redemption of money in these commodities. These proposals, designed to maintain the national income and the level of employment, were both based on the quantity approach, and are in contrast to solutions which are concerned with the spending and flow of income, with important implications with reference to government spending, the volume of private investment, and other matters of concern to government.

It is not possible to discuss here the effects upon fiscal and monetary policies of the developments in the field of monetary theory during the 1930's. Business cycle and monetary theory have become closely interwoven, and have revealed matters with important implications for government administration, such as changes in the amount of government spending and in the volume of private investment. Many writers have made noteworthy contributions to our understanding of these subjects. The theory of money and its relation to international economics are discussed further in Chapters 6, 8 and 9.

PART III

INTERNATIONAL ECONOMIC POLICIES

Chapter 17

TARIFFS AND OTHER TRADE RESTRICTIONS

Growth of Trade Restrictions.—One of the noteworthy developments of the interwar period was the movement toward economic nationalism and the consequent adoption of various measures which restricted international trade. The trend away from liberal multilateral trade policies, particularly in Europe, was pronounced during the depression period and the years of political tension which preceded the outbreak of war in 1939. These policies continued after the war despite efforts of the United States and a few other countries to turn the tide.

During the interwar period international economic cooperation was overshadowed by beggar-my-neighbor policies which gave little heed to the international aspects of measures adopted. Countries sought to achieve as much self-sufficiency as was feasible and placed restrictions on trade with other countries, especially on imports. They provided subsidies for certain exports, encouraged bilateral trade (seeking to balance exports and imports with individual countries), and manipulated exchange rates to achieve nationalistic ends regardless of the consequences to other nations. This system of autarky, in which Nazi Germany was a leader, had the effect of narrowing international trade and channeling it away from a course based upon comparative advantages and consumers' choices. The system, in varying degrees, spread from Europe to Latin America, to the British Empire and to other parts of the world. Autarkic measures were in some instances adopted in self-defense rather than because of any liking for the system.

The growth of economic nationalism during the 1930's was due to a considerable extent to the maladjustments of the depression, and represented, in part, efforts to maintain employ-

ment at home, even though the effect was to damage other countries and to lead to reprisals and to an aggregate net loss. Price and cost maladjustments and the breakdown of the multilateral trading system led to bilateral and barter arrangements in the attempt to move goods and to surmount payments difficulties. The growth of restrictive and nationalistic measures also represented maneuvering for political objectives in the threatening prewar atmosphere, as well as efforts to achieve economic preparedness. While Germany armed for aggression other countries were forced to arm in self-defense and sought likewise to obtain necessary war materials and to minimize dependence upon outside sources. Another motive behind the restrictive and nationalistic measures was the desire of producers for protection against foreign competition, a motive which has long been present in practically all countries.

The mounting barriers to international trade together with depression difficulties caused a sharp shrinkage in trade. In addition to having to contend with depressed markets foreign traders found door after door shut or only partially open. Domestic production and trade recovered from the depression more rapidly than did international trade.

The high tariff and isolationist policy of the United States during this period was the American counterpart of European economic nationalism. The policy of a high protective tariff was carried to new levels in the United States with the passage of the Fordney-McCumber Tariff Act of 1922 and the Hawley-Smoot Tariff Act of 1930, both involving steep tariff increases. These high tariffs were particularly inconsistent with the creditor position of the United States and also with this country's tendency toward an export balance, encouraged by a continuing government and private campaign to promote exports. The high tariff interfered with the shipment of goods to the United States in payment of interest and principal due this country, and was a factor in the large gold importations which came to this country in lieu of goods. Europe was left relatively short of gold and dollars, and its currencies were later unable to meet the strains of the depression. The American protectionist policy aroused retaliatory action on the part of other

countries, and contributed to further restrictions on world trade.

In 1932, Great Britain finally committed itself to a protective program after a long period of free or relatively free trade, during which time British industry and commerce had prospered greatly. British rates were in the main not high but involved a departure from the former relatively free trade status of the country, dating back to the repeal of the Corn Laws.

After the second World War the widespread devastation of productive facilities, the disruption of transportation, and the shortages of goods, together with a scarcity of means of payment for imported commodities, caused countries to continue to place rigid limitations upon imports from abroad and to enforce exchange and other restrictions. Rationing and other controls were necessary to prevent chaotic conditions. The conduct of foreign trade in the postwar period continued to a large extent to be in the hands of governments or was rigidly controlled by governments.

As reconstruction was accomplished and production recovered, governments were nevertheless reluctant to relinquish controls over trade and to allow it to develop in response to competitive forces. Once controls have been in force for a period of time, trade and production tend to become adjusted to the controls and assume a character which makes their elimination difficult. The motives or reasons behind continuance into the postwar period of the extensive system of controls and trade barriers were, varying from country to country, a mixture of the following: balance of payments maladjustments and the existence of unrealistic exchange rates which contributed to these maladjustments, a philosophy of economic planning and extensive regulation of economic life by government including the attempt to facilitate economic development and to discourage the importation of nonessentials, the desire to protect home producers from foreign competition, difficulties of returning to a free market in view of the pattern of trade and production that had been developed under the regime of controls, and caution in taking measures which to some extent had uncertain consequences and that involved political risks.

Beginning in 1934 the United States took the lead in the effort to free trade from the many burdensome controls and barriers which had grown up and which tended to prevent the full expansion of world trade and production and to reduce their flexibility, impeding economic adjustments.

Purposes of Tariffs and Other Restrictions.—One of the principal and earliest purposes of tariffs and other restrictions on imports is to limit competition from foreign producers and thereby protect domestic producers. The objective is to shut out or curtail imports and thereby raise the local prices of protected articles for the benefit of domestic producers. The imposition of tariffs in such cases is commonly sponsored by the interested producers, who in most countries have found consumer opposition relatively weak and unorganized. Consumer interests as a consequence have been commonly sacrificed to those of the producers wishing protection. The desire to aid a particular industry, however, may be for reasons other than an increase of the profits of the owners of the industry, as noted below. Benefits to producers may be incidental to a broader purpose.

The reasons for the imposition of exchange restrictions are usually somewhat different from those for tariffs and have to do with balance of payments problems as well as with protection for domestic producers. Exchange restrictions are discussed in Chapter 22.

A further purpose of import restrictions has to do with economic development. Most underdeveloped countries desire to utilize tariffs and other restrictions in connection with the planning of their economic development. They may, for example, wish to discourage the importation of luxury articles and facilitate the importation of machinery, food, and other essential goods.[1] Such countries often feel that their economic

[1] If a country desires to reduce the importation of luxury articles an excise tax, which applies to locally produced goods as well as to imported goods, will accomplish the same result as a tariff and will at the same time not provide protection to a local industry that may be ill-suited to the country. An excise tax would thus not stimulate the uneconomic allocation of resources as in the case of a tariff, that is, it would not stimulate local production of the luxury article to take the place of former imports.

progress is dependent to an important extent upon the development of domestic industry, especially manufacturing. They may therefore limit the importation of certain foreign manufactured goods. They may also desire to encourage greater diversification of production and avoid dependence upon only one or two products.

Countries that are not classed as underdeveloped may also desire to limit the importation of luxuries, or to encourage the production of particular products, or to diversify their production in connection with economic and social objectives.

Another reason for tariffs and other import restrictions has to do with military preparedness. It is not possible for a nation to be self-sufficient with respect to all military essentials, but nations may endeavor to increase their military strength by encouraging the domestic production of certain products that are especially useful in the event of war. During the first World War the United States discovered that it had practically no chemical industry. Chemicals had been imported from Germany. After the war a very high degree of tariff protection was given the new chemical industry because, among other reasons, of its special importance in the conduct of a war.

Similarly a country may restrict imports, especially of nonessentials, in order to conserve foreign exchange or to reduce a balance of payments deficit. To the extent that the exchange problem is a temporary one—and under proper financial policies and a realistic rate of exchange it should not be other than temporary—tariffs are not the most appropriate means of dealing with an exchange stringency or of restoring equilibrium, as discussed in the next chapter. A tariff, although it may force a curtailment of imports, does not remedy the cause of the trouble, nor is it sufficiently flexible for temporary situations.

An important purpose of tariffs, but not of other trade restrictions, is the receipt of revenues. Many tariffs were originally imposed primarily for revenue purposes, and in most countries today tariffs yield the government substantial sums. Latin-American countries in particular rely on tariffs as a source of funds, which fact has interfered with efforts toward a reduction of tariffs. The increasing use of the income tax, still

inadequate with low rates and poor enforcement in many countries, has relieved somewhat the dependence of certain countries upon their tariff revenues.

The same tariff that yields revenue may also afford protection and accomplish other objectives. A tariff imposed entirely for revenue purposes, however, would be applied to different commodities and have rates different from those of a protective tariff. To the extent that a tariff keeps goods from entering the country it yields no revenue. Oftentimes a lowering of the rates, affording less protection and permitting greater imports, would provide more revenue.

Tariffs are sometimes enacted for purposes of retaliation against the tariffs and other restrictive policies of other countries. The high United States tariff inspired tariffs and other restrictions abroad against this country's goods. The United States, it is to be noted, is required by law to impose countervailing duties against countries that subsidize dutiable exports to the United States. Tariffs are also adopted, or raised, to place a country in a stronger bargaining position in anticipation of negotiations for tariff reductions. The main purpose of a tariff, however, and of most other forms of import restrictions is to protect domestic producers against foreign competition.

Tariffs—Nature and Terminology.—A tariff or duty on the importation of commodities from abroad is one of the earliest methods of limiting imports. Tariffs today are only one of several devices to restrict imports, but are nevertheless of special importance in view of their substantial effects upon trade and production. They are usually of a statutory nature whereas other measures to restrict imports, such as exchange controls, are ordinarily applied with a greater degree of administrative discretion.

Nations differ in their tariff systems with respect to the nature of the commodities to which the rates apply, the height of the rates, and the manner in which the rates are applied to similar products from different countries. Nations often grant certain other countries specially favored treatment or preferences. Broadly speaking, there are four divisions into which

tariff systems or policies may be classified: (*a*) the simple policy of equal treatment to all like commodities, from whatever nation imported; (*b*) the policy of departing by treaty or convention from a general schedule of rates; (*c*) the policy of having two sets of rates, maximum rates and minimum rates, and of applying the minimum, or so-called most-favored-nation rates, to imports from countries entitled to them by treaty, and the higher column of rates to imports from other countries; and (*d*) the policy of granting exclusive preferential treatment. We shall discuss these in order.

(*a*) When a country offers equal treatment to all like commodities, regardless of the country of origin, it is said to have a *unilinear* or *single-column* tariff. Throughout its history the United States has with only minor deviations employed the single-column system, except for trade with Cuba. Other countries adhering to some form of single tariff are Argentina, China, Japan, the Netherlands, Switzerland, and the Scandinavian countries. After the first World War, and particularly after 1929, there was a trend away from unilinear tariff schedules toward more complicated structures. Less industrialized nations sometimes have had simple tariff systems in which a single low rate was levied on all imports, without regard to their nature. Tariffs of this type were primarily for revenue.

(*b*) Another type of tariff system is the *general-conventional* tariff. This provides for a so-called general column of duties, usually established by statute. The general column applies to all countries except those with which tariff treaties or conventions have been made. The lower rates granted by these conventions constitute the conventional schedule. The principal advantage of such a system is its flexibility in tariff bargaining. Australia, Chile, Czechoslovakia, Finland, New Zealand, and Turkey have general-conventional tariff systems.

Certain nations, such as the Netherlands, Switzerland, and the Scandinavian countries, employ a form of general-conventional system which in practice is a single tariff. These countries grant conventional reductions to particular countries, but immediately extend these reductions, as a matter of policy to

all countries. Thus they grant equal tariff treatment, and to all intents have a single-column tariff.

(*c*) A number of countries have tariff systems which provide by statute for *maximum and minimum* rates for like commodities. In most instances of this kind, the minimum rates are granted to countries with which trade treaties have been made entitling them to rates granted most-favored nations, the maximum rates applying to all other countries. The chief advantage of such an arrangement is that it encourages foreign nations to grant tariff favors, and at the same time permits the raising of the minimum rates by statute without violating treaty obligations. Increasing the minimum rates, however, is a sure means of incurring the resentment of the foreign treaty nations, and from the economic standpoint is probably not an advantage except to the protected industry. Countries with maximum-minimum tariff arrangements include Brazil, Greece, France, and Poland.

Canada has a three-rate tariff system, providing for minimum, conventional, and maximum schedules. The minimum rates are extended to the various parts of the British Empire, the conventional or intermediate rates to countries with which tariff treaties have been made, and the maximum rates to all other nations.

(*d*) No nation in recent times has pursued a policy of *exclusive preferential* treatment, a policy which, carried to its logical extreme, would involve making all tariffs on imports from every nation a matter of exclusive bargaining. France on two occasions attempted a program pointing in this direction, but was forced to virtual uniformity in the application of its minimum schedule. Somewhat similar to such a policy is that pursued by a number of countries which grant exclusive trade privileges to nations related to them by political, racial, or regional ties. Thus, member nations of the British Empire extend exclusive concessions to other member nations, and the United States grants favors of an exceptional nature to Cuba and the Philippines.

Tariff duties that are assessed and collected on the basis of some physical unit, such as so many dollars a bushel, ton, or

yard, are called *specific* duties. Those, on the other hand, that are calculated on the basis of the value of the goods are said to be *ad valorem* duties. The value is considered by the United States generally and a few other countries to be that at the place of shipment of the goods, and is determined by the invoice of sale or by a customs appraiser.[2] In some cases, the duty collected is based upon a combination of the two methods; for example, ten cents on each 100 pounds plus 15 per cent of the value. This type of duty is commonly designated a compound duty.

When commodity prices are declining, specific duties, which remain the same in dollars and cents even though the goods sell for less, become relatively more burdensome to the payer of the duties, and also afford relatively more protection. Thus a duty of ten cents on each 100 pounds is, from the percentage standpoint, less burdensome when the goods sell for $1 per 100 pounds than if the price declined to seventy cents. Conversely, when prices are rising, specific duties become relatively lighter, and give less protection. Ad valorem duties, on the other hand, vary in amount with the value of the goods, and tend to yield about the same degree of protection at any given level of commodity prices. When a particular foreign article, however, declines in price, the cheaper the article becomes the less is the protection to domestic competing goods afforded by an ad valorem duty.

The term *drawback* refers to a duty which has been paid on imported goods, and which is refunded by the government if the goods are re-exported. In the United States, no drawback is allowed unless the goods have been processed in the United States, e.g., if duty-paid sugar is used in canned fruit exported. *Compensatory* duties are those which are levied on imported goods for the purpose of raising their prices to protect domestic producers because of duties on raw materials entering into the manufacture of such goods. For example, a compensatory duty is levied on imported woolen textiles because of the duty upon wool.

[2] Most countries consider the value to be that of the goods landed within the country, or the cost plus insurance and freight (CIF).

When foreign countries aid certain of their producers by granting them subsidies or bounties, other nations may impose *countervailing* duties on the importation of such subsidized articles, in addition to duties previously in effect, to insure the degree of protection originally intended. Goods which are not subject to duties of any kind are said to be on the *free list.* Many countries have no free list but exempt certain items scattered through the schedules. When a government agrees with a foreign government not to alter a certain rate of duty, such rate becomes *bound.* The United States has agreements with various countries wherein both countries bind certain rates.

In the United States, tariffs are levied only upon the importation of goods. The exportation of goods is entirely free of duty, as provided in the Constitution, although certain exports may be and are controlled for security or other reasons. Many other countries, however, levy export duties. Trade between the different states in the United States is also free of duty according to the Constitution. Interstate free trade had not been provided in the Articles of Confederation. To protect themselves against agricultural pests, states sometimes prohibit the entry of certain articles from other states. They have also devised various restrictions upon the movement of certain goods across state lines, and have utilized sanitary controls for protective purposes largely unrelated to sanitation or health. Such restrictions are, of course, not in the form of tariff duties, but have much the same effect, and are for essentially similar purposes.

In 1937 the United States established in New York what is known as the Foreign Trade Zone, where goods can be received from foreign countries, stored, repacked, sorted, etc., and re-exported without the payment of duty to this country. Similar zones have been established in other United States ports.

It is well-nigh impossible to measure with any accuracy the amount of protection afforded by a particular tariff, or to compare the height of the tariff of one country with that of another, or with that of an earlier tariff in the same country. An average of the percentages of duty is misleading since a large number

of low rates on unimportant commodities may overbalance and conceal high rates on a few major commodities. Only general comparisons may be made since it is not possible to know precisely the amount of imports that would otherwise have entered the country. If it is said that the great bulk of imports come in free of duty or under low rates it does not necessarily follow that the tariff as a whole is low and of little effect. Some rates may in fact be so high as to keep out practically all imports of certain commodities. Moreover, the elasticities of the different commodities vary and the extent to which a tariff shuts out imports is not indicated solely by the height of the duty. A fairly low rate may have considerable effect in the case of a commodity with high price elasticity. An identical rate of duty on a certain commodity in different countries may have quite different effects. In one country the commodity may be produced domestically on a low cost basis and the producers not be hampered greatly by competition of imported commodities. Whether the tariff were high or low would make little difference. In another country, however, the producers may be dependent to a considerable extent upon the tariff.

Quantitative, Exchange, and Other Restrictions.—Prior to the 1930's the principal method of limiting imports was the imposition of a tariff. As a result of the depression and the growth of economic nationalism various other methods were developed to prevent or restrict imports and to control trade generally. With the introduction of other types of trade restrictions tariffs became relatively less important in many countries (although not in the United States), but nevertheless continued as a major barrier to trade. In addition to tariffs the principal measures, adopted to a large extent for the first time during this period, which have been utilized extensively to restrict or regulate trade are as follows:

QUANTITATIVE RESTRICTIONS. Direct limitations upon the physical amounts of certain commodities that may be imported (or exported) during a certain period of time are known as quantitative restrictions, sometimes referred to as QRs. Countries employing this type of restriction establish a system of licensing

imports. Quotas for the different commodities to which the restrictions apply are often established, and imports of these commodities are limited to the quotas. The quotas are frequently allocated among the several supplying countries, the amount or share allowed to each country being based upon imports during some previous representative period, or the quotas may be determined on some other basis or more or less arbitrarily.

Quotas were employed at first largely as a defensive measure, especially in connection with exchange depreciation of foreign currencies, and were regarded as temporary in character. It was not long, however, until they were discovered to be useful tools for continued protection against foreign competition, and the attainment of political and other objectives. They soon came to be regarded as an inherent part of the machinery of trade regulation for whatever purpose the restriction was imposed. The exchange difficulties which quotas were originally intended to relieve, were not so much shortages of foreign exchange as excessive imports of particular commodities from countries with depreciated exchanges. Quotas, however, were also used to strengthen exchange reserves by limiting imports. Exchange control was repugnant to banking and other financial interests in the larger European countries, and where reserves were under pressure the quota system was a more acceptable method of reducing drawings on the exchange reserves. After the second World War, when most countries suffered from exchange shortages, quantitative restrictions were extensively utilized to restrict imports and thereby to limit the demands on reserves.

The first country during this period to adopt the quota system extensively was France which inaugurated quotas in May, 1931, prior to the collapse of the pound sterling in September of that year. Low agricultural prices had prevailed throughout the world prior to the abandonment of gold payments by Great Britain in September, but the depreciation of currencies after the collapse of the pound threatened European countries with increasingly heavy imports of cheap agricultural products from non-European areas. This condition contributed

to the rapid spread of the quota system during late 1931, 1932, and the years following. The quotas, which were originally aimed to exclude excessive amounts of the cheap agricultural products of the countries whose currencies were depreciated, were at the outset usually applied against only a few items. The system, however, expanded rapidly as more and more articles were added. France, for example, which started the system in 1931 had by 1934 placed over 3,000 articles on the quota list. Rumania started with 120 articles in November, 1932, and by the following July had made 500 articles subject to quotas.

With the aim of freeing international trade from the numerous restrictions that had grown up, the United States after the second World War took the initiative in endeavoring to eliminate quantitative restrictions, except under special circumstances. In the charter of the proposed International Trade Organization, sponsored particularly by the United States (but not accepted by the United States Congress), the general rule was laid down that members should not utilize quotas for either imports or exports except, in the case of exports, when there was a critical domestic shortage of food or other essential products, or, in the case of imports, when applied against agricultural products provided the domestic supply was also restricted and the quotas were not used as a protective measure to increase the share of domestic producers in the home market. Further important exceptions provided that quotas might be applied to imports, under specified conditions, to facilitate economic development (certain countries, for example, desire to use quotas to promote industrialization), and to help relieve balance of payments difficulties by reducing selected imports. These exceptions are fairly broad, but were insisted on by several nations.

EXCHANGE RESTRICTIONS. The subject of exchange restrictions is discussed in Chapter 22, but a list of the nontariff measures developed during the 1930's to restrict or regulate trade must give prominence to this device. Quantitative restrictions and exchange restrictions constitute the two principal nontariff control devices.

The maladjustments in foreign trade brought about by the depression, especially the unbalanced nature of the declines in exports and imports, caused a shrinkage in foreign exchange reserves of many countries. In order to prevent or limit exchange depreciation governments undertook to ration the available supply of foreign exchange. To purchase foreign exchange with which to pay for imported goods or to make a foreign payment it became necessary first to obtain a license from the central bank or some other government agency. The purchase and sale of all, or largely all, foreign exchange was subject to strict government control.

Control over the purchase and sale of foreign exchange was soon recognized as an effective means of restricting imports for whatever purpose desired. It was used not only to protect exchange reserves but to keep out certain types of foreign goods, and also as a political weapon.

According to most exchange control systems goods are classified into categories according to their essentiality, and priority in the sale of exchange is accorded to the categories considered to be the most essential. While exchange restrictions have certain advantages in dealing with temporary or emergency shortages of exchange wherein disorderly exchange conditions would otherwise prevail, as a permanent or long continued arrangement they have serious drawbacks especially in their tendency to distort trade and production away from the most efficient lines and to reduce the total volume of trade, as noted below. Moreover, exchange restrictions involve difficulties of enforcement and lead to more or less extensive black market corruption. One of the objectives stated in the Articles of Agreement of the International Monetary Fund is "the elimination of foreign exchange restrictions which hamper the growth of world trade."

Multiple Exchange Rates. Multiple rates are also discussed in Chapter 22, but constitute an additional means of restricting imports and should be mentioned here. According to multiple rates systems, different exchange rates are established to apply to different kinds of foreign trade transactions.

An import of a certain commodity is paid for with foreign exchange bought at one rate, whereas the import of another commodity requires that exchange be bought at a different and more or less favorable rate. Such a system, it can be seen, may be used effectively to restrict or to favor certain imports. Multiple rates may also apply to exports and may thereby be used to extend encouragement to the export of certain commodities.

While under certain conditions multiple rates might be used to accomplish legitimate objectives, they are a discriminatory device and have been subject to considerable criticism. They introduce needless complications into foreign trade transactions since the objectives of multiple rates can be accomplished in other ways. The International Monetary Fund is opposed to multiple rate systems.

Sanitary Regulations. The importation of certain commodities is frequently prohibited or restricted in the interests of the health and welfare of the population. Restrictions of this type, which have a long history, endeavor particularly to keep out agricultural pests or diseases. They may be temporary or more or less permanent, and usually apply to commodities from a certain infected area. Sanitary regulations are frequently subject to abuse or to suspected abuse. They are at times utilized, it is charged, to limit competition rather than because of the need of protection against disease. Argentine cattle growers are convinced that the United States ban on the importation of Argentine beef is not because of the danger of hoof-and-mouth disease so much as to protect the United States market for domestic beef. American cattle growers, on the other hand, express fear of an outbreak of the disease such as occurred in the 1920's in California.

Import Surtaxes. Some countries apply special taxes on dutiable imports levied in addition to the regular duties. Before the war France and other gold standard countries imposed surtaxes on imports from certain countries with depreciated currencies. In Latin America surtaxes have been used to obtain revenue for specific purposes.

Labeling Requirements. The United States and other countries require precise markings on certain imports. The rather rigid American labeling regulations have caused other countries similarly to impose severe requirements in connection with the labeling of American articles. When labeling requirements are altered without adequate warning severe losses may be suffered. Such requirements are an annoyance and a handicap to trade.

Miscellaneous Restrictive Measures. Other measures which restrict trade include bounties or subsidies to domestic producers, so-called antidumping duties, mixing regulations, and certain types of internal taxation. Government subsidies may take the form of production bounties, or of export bounties. Both of these give the domestic producer a competitive advantage. A production bounty stimulates domestic production and discourages imports of the subsidized commodity. In its effect it is not unlike a tariff. An export bounty stimulates exports, and can hardly be called a trade barrier, although it alters the pattern of trade and is regarded by competitors in other countries as an unfair device. Several nations have antidumping duties which are levied upon imported goods sold at less than their market prices in the country of origin. Other nations give more or less arbitrary powers to the Executive to deal with dumping. The United States Antidumping Act of 1921 provides that,

> If the purchase price or the exporter's sales price is less than the foreign market value (or in the absence of such value than the cost of production), there shall be levied, collected and paid, in addition to the duties imposed thereon by law, a special dumping duty in an amount equal to such difference.

In some cases, antidumping duties have more than compensated for price differentials.

Certain countries have introduced so-called "milling quotas," or mixing regulations as a restrictive measure, requiring that all domestic flour be milled from blends containing a stipulated percentage of home-grown grain. Similar to these are "linked-purchase" regulations, which require for every import a fixed

proportionate purchase of domestic articles. Several nations have required that imported moving picture films be shown only to a certain proportion of domestic films. Such regulations are aimed particularly at United States films. Internal excise taxes on products depending largely on imported raw materials for their manufacture are, in effect, the same as tariffs, and may be levied for no purpose other than the exclusion of the foreign commodities involved.

The various devices which are utilized to restrict foreign trade, especially imports, constitute together a serious barrier to the expansion of foreign trade. The United States, in the endeavor to facilitate the growth of world trade, has sought to get nations to simplify and reduce these restrictions. It has accomplished considerable in this direction, as noted below, but much remains to be done.

Most-Favored-Nation Principle.—Countries frequently enter into treaties or agreements which are concerned with tariff and other treatment accorded to each others' products. Commercial treaties, as discussed in Chapter 31, usually cover a variety of subjects, but one of the main subjects dealt with has been that of tariffs and other restrictions on trade.

An important provision in such treaties and agreements is that which assures the parties to the treaty what is known as "most-favored-nation" (mfn) treatment. As applied to tariffs this provision means that the products of a country assured such treatment will in each case enter at rates of duty no less favorable than those applied to like products of any third country.

Most-favored-nation clauses are of two types—unconditional and conditional. The more liberal of these is the unconditional, which assures that both contracting states will automatically and unconditionally extend to each other all favors granted to a third nation, without regard to any favors that may have been awarded by the third nation. The conditional most-favored-nation clause guarantees that the two contracting nations will extend to each other all favors granted to any third nation, on the condition that each contracting nation extends to the other privileges equivalent to those received from the third nation.

Until the first World War, the United States employed the most-favored-nation principle in its conditional form, whereas European countries, after 1860, made general use of the unconditional type. Since 1923, however, the United States has employed the unconditional most-favored-nation clause in its treaties and agreements, while many European countries have sought to get around the unconditional most-favored-nation clause in various ways, e.g., denying its application to quota and other restrictive devices. The conditional clause, however, has not reappeared, with one or two minor exceptions.

The most-favored-nation principle, especially in its unconditional form, promotes equality of treatment. A nation which enters into unconditional most-favored-nation tariff treaties with other countries is thereby compelled to grant equal tariff treatment to all those countries. However, with respect to any particular commodity, a tariff concession benefits countries differently, depending upon the extent to which the country exports the commodity in question. This variation in benefit permits tariff bargaining under the unconditional most-favored-nation principle. The extension of the principle also may simplify tariff arrangements. A short-run effect is to reduce rates of duty, but since 1875 the unconditional most-favored-nation clause coincided with a steady and wide growth of protective tariffs. It is not, therefore, a device of tariff reduction.[3]

[3] For a further discussion of the Most-Favored-Nation Principle see Chapter 31, Commercial Treaties.

Chapter 18

ECONOMIC ASPECTS OF TRADE RESTRICTIONS [1]

Advantages of Unrestricted Trade.—The advantages which result from trade between individuals or between nations include the advantages which come from the division of labor and specialization in production. Through trade it is possible for people to have more and better commodities than if they were dependent upon their own direct efforts for all types of articles. Trade makes possible large-scale production and the utilization of elaborate and expensive equipment. It permits the location of plants in favorably situated areas, the acquiring of special skills, and a more efficient utilization of abilities and resources.

A large and growing trade indicates progress, advancement in productive techniques, increasing economy in the use of resources, and a better division of labor with a resulting larger output. It provides outlets for expanding production and leads to more commodities to consume and a higher standard of living. It means that there is less attempt to grow wheat on poor land or with inefficient methods, and to produce steel where there is a lack of plentiful supplies of ore, coal, and other essentials. The law of comparative advantage teaches that nations tend to produce articles in the production of which they have special advantages, as noted above. A large and growing trade, unhampered by restrictions, indicates that special advantages are being utilized, and that countries are tending to make

[1] The various types of restrictions will not be specifically mentioned. Their effects are in general similar to those of a tariff which is the principal restriction referred to in this chapter. See also Chapter *22*, "Exchange Restrictions—Multiple Rates."

the most of their opportunities. Trade, therefore, is to be encouraged, imports as well as exports.

The advantages of allowing trade to develop along natural lines, and of permitting each region to produce and trade freely those things which it is best fitted to produce, are illustrated by the large and efficient production within the United States, where a large population living over a great expanse of territory, produce and trade with each other without the handicaps of trade barriers. Production in the United States has been allowed to become highly specialized. Automobiles are made in Detroit and neighboring areas; steel in Pittsburgh, Chicago, and other centers; and shoes in New England, New York and St. Louis. The high per capita production in the United States and the high standard of living are, of course, not to be attributed solely to freedom of trade among the states, but this freedom, along with the help of a common currency and other conditions which facilitate trade, is an important factor.

As it is desirable economically for California to trade freely with New York and Massachusetts, and for Oregon to trade with Pennsylvania, so it is also desirable for these states to trade with Canada, England, France, Brazil, and other countries. Trade between two or more people brings a net gain to both parties, whether they are neighbors or live on opposite sides of the earth. The advantages of trade are self-evident and do not need elaboration. Trade, if left alone, pays little attention to what flag flies, unless forced to do so by artificial barriers.

Tariffs and other measures which restrict international trade limit realization of the advantages noted. They interfere with the organization of production on the basis of comparative advantages and consumer's choices, curtailing the freedom of consumers to buy where and what they wish. They discourage production by the most efficient and low-cost producers unless such producers are within the country's borders. Tariffs or other restrictions thus alter the allocation of resources away from the most efficient pattern, and away from the production of the kinds of articles and in the amounts desired by consumers. They usually reduce the volume of trade and cause imported goods to be scarcer and higher in price than would otherwise

e the case. In some instances tariffs may affect (favorably) he terms of trade, as well as the distribution of income among ie factors of production, particularly within the country. 'heir effects are not as simple as was assumed by the classical conomists, but in most instances, as the classical economists ointed out, are harmful to consumers.

Effects of Tariffs on Prices.—The first effect of a new ıriff is for the cost of the goods to be higher to the importing ouse because it must pay the new duties to the government. .n effort will be made by importers to raise the price of the oods to the public, perhaps by the full amount of the duty, ut if this interferes with sales the importing house may sell n a closer margin of profit and pocket some of the loss ocısioned by the new duty. The foreign exporters of the article, s they find their sales reduced, may cut their selling prices omewhat, thereby bearing part of the duty themselves. These fects, which depend largely upon the elasticities noted below, nd to be temporary, since the importing house and the forgn producer will not be willing permanently to accept profits elow the usual level. As the capital and efforts of importers nd foreign producers are attracted to more lucrative fields, ie price of the commodity in question tends to rise, and the ırden of the duty tends to fall upon the domestic consumer.

Matters however do not always work out as precisely as this easoning implies. Profits may already have been above the oing level, or may for a long time continue below this level, ie producers hesitating to change their businesses, perhaps beuse of large fixed capital investments. Sooner or later, hower, the consumer tends to bear most of the burden of the uty whatever this may be. If he buys imported goods which e cheap abroad, he pays a duty to the government. If he ıys domestic goods he pays in a higher price what amounts a bounty to the domestic producer. A tariff is similar to a ıbsidy to certain producers, paid for not by the federal Treasy, but paid directly by the purchasers of the article.

A commodity the importation of which is reduced by a tariff other restriction from what the importation would be with-

out such restriction thus tends to become higher in price domestically than it would otherwise be. The amount of the price increase because of the tariff may vary from zero to even more than the amount of the duty. The precise amount of increase depends particularly upon the extent to which the market is supplied from foreign sources, and upon several price elasticities, for example, that of the domestic demand for the article (if the demand is elastic so that a higher price cuts off a large amount of sales, sellers may absorb some of the duty, at least for the time being, and the price rise may be less than if sales were not greatly affected), that of the foreign supply (the foreign supply offered may, if elastic, be materially curtailed by the tariff which to foreign suppliers is probably similar to a lower selling price received by them, or, if inelastic, such supply may be affected only slightly), and that of the domestic supply of similar articles that tend to take the place of the excluded article (the domestic supply of similar articles may expand considerably with a small price increase and thereby fill the gap, or it may not expand greatly so that a considerably higher price may result). If importation of the foreign commodity is restricted by means of a quota or by exchange control the effects of the restriction on the domestic price may not be influenced by the foreign elasticity of supply, since the amount admitted is in any event fixed more or less rigidly.

Changes in the output of the dutiable goods may change the costs of producing those goods, although if the goods are produced under conditions of constant costs the domestic supply may expand and be sold at the former price, so that little or no change in price results. If a smaller volume is produced because of the tariff, this smaller production, whether domestic or foreign, may mean a higher unit cost. Some of the economies of large-scale production may be lost, and the producing costs may go up. The higher costs of the reduced supply may cause the selling price of the article to rise by an amount even greater than the tariff. This situation, an industry of decreasing costs (with larger output), would give still greater protection to the domestic producers, and cause a still higher price for the article to the consuming public. On the other hand, a

smaller volume of production may mean lower unit costs. Under such conditions of increasing costs the price of the protected article would tend to go up by an amount less than the tariff or perhaps not at all.

The price of a protected article may also be affected by many indirect influences. A reduction in imports because of the tariff may have repercussions upon monetary reserves (increased through payments for exports), the amount of exports, the rate of exchange and upon imports of commodities other than those subject to duty. Reduced imports may lead to an inflow of gold, an increase in the monetary supply, appreciation of the exchange rate, fewer exports and perhaps larger imports of unprotected items. It can be seen that the ramifications of a duty may be extensive and that the precise effects upon prices are difficult to trace.

Tariffs and the Terms of Trade.—A tariff or other import restriction may alter the terms of trade, i.e., the amount of imports received for exports, in favor of the country imposing the tariff, especially if the foreign demand for the country's exports is large and inelastic.[2] A tariff which curtails imports thereby increases the difficulty for foreigners in earning such country's currency needed to pay for purchases there. Foreign countries, perhaps with a strong demand for the other country's goods, but with their exports to such country hampered by the tariff, may have to give more of their own exports (at lower prices) in order to earn the same amount as before of the other country's goods. A tariff may thus cause a reduction in the prices of imported goods relative to the prices of exported goods. The means by which this adjustment comes about may involve an alteration of exchange rates.

A tariff which reduces imports would cause a shortage of the country's currency in the hands of foreigners, and would therefore, under a system of freely moving exchange rates, cause the exchange rate of such a country to move toward a higher level, one which appreciated the country's currency. Foreign goods would thereby become cheaper in terms of the country's

[2] See Chapter 12, "Terms of Trade."

own currency. Exports, which are sold on the world market, would be essentially unchanged in price, but would yield more local currency at the higher exchange rate so that imports would have become cheaper in terms of exports. In order that imports and exports may equilibrate in value, a larger volume of imports would be necessary to equal the same value as before the tariff.

If in the country imposing the tariff the exchange rate were fixed under the gold standard, price movements would tend to bring about the adjustment, i.e., prices in the country with the tariff would tend to rise as gold was received to pay for such country's exports, formerly paid for by imports, and prices abroad would tend to fall as gold reserves there declined. If a fixed exchange rate is maintained by control devices and if gold movements have little effect upon the price level, as is the case in most countries today, an adjustment in the terms of trade may take place through a reduction in the individual prices at which foreign goods are offered, or if the foreign country, lacking foreign exchange, limits foreign purchases by control devices the terms of trade may not be greatly affected.

Under certain conditions of international demand, therefore, it is not impossible that the external purchasing power of a country's exports may be increased by a tariff on imports, or in other words, that the terms of trade may be improved. While it is possible that such an improvement in the terms of trade, representing an increase in real income, might take place and might more than offset the disadvantages of the tariff (such as the unfavorable effects on the allocation of resources), a net gain does not appear likely under most circumstances. Any gains in real income, moreover, would be achieved at the expense of other countries, and there would be no net gain from the standpoint of all trading countries.

To the extent that a tariff improves the terms of trade of a country it may thereby reduce the amount of protection afforded by the tariff, since foreign goods become relatively cheaper and more of such foreign goods are imported in exchange for exports. In the case of a country with a protective tariff and whose exports are sold under conditions of inelastic

demand, it is possible, paradoxically, that the tariff may lead to more imports and that a reduction of the tariff would increase the protection. A reduction of the tariff might worsen the terms of trade and cause imported goods to be more expensive than formerly, thereby favoring the purchase of domestic goods.

Tariffs and the Distribution of Income.—A tariff may also alter the distribution of income among the factors of production. If a tariff stimulates domestic manufacturing it increases the demand for factory workers. While certain export industries, perhaps agriculture, may be depressed as a result of the tariff's reduction of imports and consequently of exports, the manufacturing industries stimulated by the tariff may utilize a larger proportion of labor than the industries that are depressed, so that a net increase in the demand for labor results. The proportions in which the factors of production are combined in the export industries, such as agriculture, are not exactly the same as in the industries competing with imported goods, such as manufacturing. Agriculture may require fewer workers in relation to capital such as land, tractors, etc., and in relation to the value of the product. A tariff may thus affect differently the domestic demand (and also the foreign demand) for various factors of production, and thereby alter their relative rewards. This subject was discussed in Chapter 10.

Tariffs and the Balance of Payments.—A tariff or other restriction which reduces imports thereby affects the country's balance of payments. The decline in imports may help promote equilibrium, as in the case of a country which has a deficit in its international accounts, or it may contribute to disequilibrium as in the case of the United States which has ordinarily had a surplus of export or credit transactions. A tariff, however, is not the most appropriate means of restoring equilibrium in the balance of payments nor of dealing with an exchange stringency, except perhaps in special situations. While a tariff may curtail imports it does not get at the source of balance of payments or exchange difficulties. A fundamental maladjustment in the balance of payments and a chronic shortage of foreign exchange are preferably corrected by such measures as an exchange rate

adjustment or internal monetary and fiscal measures. In emergency situations exchange restrictions or other devices may be temporarily utilized to allocate limited exchange resources to desired imports and thereby to limit imports, although these measures have their disadvantages. Tariffs in many countries are of a statutory nature and are not sufficiently flexible to deal with temporary emergency conditions.

A high tariff policy by a country which is a creditor on capital account adds to the difficulty of foreign debtors who must make payments to such country. The United States with large amounts owing it from abroad is in such a position. Payments of interest, dividends, profits or return of principal require the sale of foreign goods or services to the United States. This country's tariff, which discourages imports, makes it more difficult for foreigners to earn the dollars with which to make payment, or with which to purchase the large volume of United States goods and services which the world needs and which the United States in its own interest must export.

Customs Unions.—Countries, especially those which are contiguous to each other, sometimes establish among themselves a customs union, which means that trade between the two or more participating countries is not subject to customs duties, and also that the countries maintain the same duties against outside countries. In the case of a free trade area, which is different from a customs union, trade barriers between the countries are substantially eliminated, but the barriers imposed by the member countries against outside countries may differ from member to member.

A genuine customs union is rare because of the difficulties of arriving at a mutual agreement. A significant example of a customs union is that between the Benelux countries, Belgium, the Netherlands, and Luxembourg.[3]

A main purpose of a customs union is to expand the trade between the participating members. In some respects a customs union is a move in the direction of freer trade. On the other hand, it may be merely the conferring of trade preferences on

[3] For a discussion of Benelux see Chapter 38.

the participating countries, and may give encouragement to uneconomic industries. The elimination of customs duties between certain countries may thus result in the building up or expansion of a high cost industry in one of the countries which, as a result of the customs union, has a protected market in the other country or countries. The shift in the source of supply brought about by the customs union may be to a higher cost producer and away from a lower cost and more efficient producer in a nonparticipating country.

On the other hand, the shift may be to a lower cost producer, in which case the customs union contributes to an economic allocation of labor and resources. A widening of the area of free trade as a means to a general reduction of trade barriers is, of course, a desirable objective. Such widening through a customs union, however, can be little more than the granting of preferences to neighbors.

To the extent that a customs union results in entirely new trade it is in harmony with the objectives of freer trade. To the extent that it leads to a replacement of outside trade by local trade it is an expansion of a protected area and tends to harm outside countries. A customs union is thus not necessarily a move in the direction of freer trade and more efficient production.

Protecting Infant Industries.—Much has been written about the economic basis for protecting new or infant industries as they are called. It is urged that a country may have comparative advantages along certain lines but that production may be unable to get started in these lines because of competition from strong, well-established foreign enterprises. It is argued that once the local industry is established it can stand on its own feet and that protection can then be withdrawn. The early tariffs in the United States were urged for these reasons. Alexander Hamilton favored moderate duties so as to encourage the development of manufacturing.[4] United States manufacturing encountered severe competition from British industries,

[4] Alexander Hamilton's views on protection are discussed in the next chapter.

especially after the War of 1812, and found difficulty in getting a foothold.

The economist Friedrich List, who settled in the United States in the 1820's, after having been expelled from the German parliament because of his ideas which were then regarded as radical, saw the difficulties young American industries were encountering from competition with established foreign companies. He favored moderate duties to help these industries. He believed, however, that the duties should be relatively low, not over 25 per cent, lest they encourage industries unsuited to the country. He also said that the duties should be temporary, that they should last not more than twenty to thirty years, and that if an industry could not by that time compete with foreign goods it should not be fostered. He recognized an immediate loss from protective tariffs but felt that ultimately the country would gain by having industries of its own that were suited to the country. List, in 1832, carried his ideas back to Germany where he saw a similar situation in that industrial development there was in its infancy and handicapped by established foreign industries. Germany was in a period of transition to modern conditions.

List did not believe that protective duties were desirable to help young industries in all stages of a country's development. He noted four periods in the economic development of countries. The first and most primitive is that in which agriculture is aided by imports of manufactured goods, and in which a tariff would therefore retard development. In the second period domestic manufacturing is beginning to grow and may, he thought, be furthered by a tariff until such time as the industry is well established. In the third period domestic manufacturing largely supplies the home market, and a tariff may still be helpful to industry. In the fourth period the country exports a large amount of manufactured products and imports raw materials and agricultural products. No tariff, he said, should be in force during this last period.

The United States is now in List's fourth stage and is no longer a weak country struggling to develop its industries. Most United States industries need no protection to compete

successfully with foreigners, as evidenced by the country's large export trade. The few industries that need protection to live are, because of that fact, unsuited to this country. The country is, therefore, not using its energies most effectively when maintaining industries in which the country does not have special advantages. In protected fields the establishments which would be unable to compete without a tariff are the high-cost producers, which economic forces would otherwise weed out in favor of lower-cost producers. Tariffs impede the working of this principle of survival of the fittest and interfere with the most efficient utilization of resources.

The extent to which the industrialization of the United States was furthered by the country's protective tariff policy is a subject to which no precise answer can be given. It is generally believed that until after the Civil War the tariff had a relatively minor effect on the growth of manufacturing industries. During this period the world demand for United States exports was fairly inelastic with regard to price. Certain individual industries doubtless benefited from the protective duties granted them, but the tariff may have altered the terms of trade in a manner adverse to local industry taken as a whole. The tariff during this period appears to have increased somewhat the amount of foreign goods which this country received in exchange for its exports, which was not the purpose, however, for which the tariff was adopted.

After the Civil War American exports came to consist more and more of manufactured articles for which the world demand was less rigid than for the primary products. The terms of trade were then affected less than formerly by the tariff which yielded substantial but unneeded protection, tending to raise domestically prices of the articles subject to duty. By this time the United States was no longer an underdeveloped country. Its industries were strong and well established, and in general able to meet competition without protection. Certain industries, however, have been fostered which are not suited to this country and which involve an uneconomic allocation of resources. These industries may require protection if they are to be profitable.

One of the difficulties of fostering young industries by a tariff is that of determining which industries are suited to the country and might be encouraged, and of avoiding assistance to industries which cannot survive without government aid. Furthermore, industries resist the removal or reduction of a duty, and once a duty is imposed its removal or even reduction becomes difficult even though the duty is not needed.

Protectionist Fallacies.—In the political debates over the tariff question, which have taken place over many years, arguments have been offered by both sides which to the trained economist are fallacious. Ardent free traders have at times made sweeping and unwarranted claims of the advantages which would come from free trade. The great bulk of the fallacies, however, may be laid at the door of the protectionists. Some of these fallacies are as follows:

CHEAP FOREIGN LABOR. One of the commonest and most plausible arguments for a tariff is that foreign goods must be kept out of the country so as to protect the wages of the American worker against the importation of goods produced by cheap foreign labor. It is said that American producers cannot compete with foreign producers who pay low wages, and that without a tariff American wages would fall to the foreign level. In order to maintain the high American standard of living it is said, therefore, that a tariff is necessary.

It is, of course, correct that in some lines of industry the United States is unable to compete with foreigners, either because of low foreign wages or advantages of other kinds which foreigners possess. The United States cannot expect to excel in every line of activity. There are plenty of lines, however, in which America can successfully compete and undersell the foreigner in his own market. American goods produced by high wages are sent to all parts of the world, and offer the strongest kind of competition to the foreign producer who pays lower wages. This fact indicates clearly that American costs for these goods are lower even though wages are high. High wages and high costs are not synonymous.

Real wages, as well as monetary wages, are high in America, not because of protection but because of the superior productive advantages and equipment in this country, the rich resources, the skill and technical knowledge available here, and other favorable conditions. Labor is relatively scarce as compared to capital equipment and other factors of production. Because of this situation the productivity and wages of the American workmen are high, and a high standard of living prevails. American capital and labor are effectively applied, and high wages do not necessarily mean high costs in general. They may mean high costs for goods requiring large amounts of hand labor but not for goods in general.

If a particular industry in America cannot afford to pay the going rate of wages and be able at the same time to compete with the foreigner, it is because other domestic industries are bidding higher for the services of the worker, since his productivity with them is high. These other industries have set a standard of productivity and pay which the weaker industry is not able to maintain. They attract the labor and capital. It is unfortunate for the weak producer, but survival of the fittest, according to fair rules of the game, gives the best results in the long run.

If an industry is unable to pay the high level of wages prevailing in America and to compete with foreign industries, that industry should not be artificially supported, unless special circumstances justify assistance. The existence of an artificially supported industry means that American labor and capital are being expended upon the production of articles which foreigners can produce more cheaply than we can. American labor and capital, therefore, can better go into other fields in which this country has an advantage over the foreigner. Such favored fields exist in abundance in the United States. The fact that American goods, produced by the highest paid workers in the world, are able to go all over the world, bearing transportation and other costs, and to sell for less than goods produced by foreign low-paid workers, is answer sufficient to the argument that a tariff is necessary to maintain high wages.

It is, of course, true that industries which depend upon a tariff in order to survive could not afford to pay high American wages were it not for the tariff. In such uneconomic industries high wages may be said to depend upon protection, since if such industries are to obtain workmen they must pay the going rate of wages, which has been set at a high level by the more efficient industries. To do this they must sell their products at high prices which can be maintained only by tariff protection.

While high wages are not dependent on a tariff, it is not impossible that because of the tariff they are slightly higher than they would otherwise be. A tariff may expand the production of goods requiring large amounts of labor and thereby increase the share of the income going to labor, at the expense, however, of the share going to other factors. This subject was discussed above.

A COMPETITIVE TARIFF TO EQUALIZE COSTS OF PRODUCTION. Tariff exponents have at times declared that they favored a tariff sufficiently high to equalize high costs here with low costs abroad. Such a tariff is sometimes referred to as a "competitive tariff." The aim would be to have duties equal to the difference between the high costs here and the low costs abroad.[5]

Two difficulties are involved in this idea. In the first place, monetary costs in any industry show a great deal of variation from one producer to another. Some producers have low costs and large profits, while others have high costs and may even be operating at a loss. The question is, whose costs are referred to, both here and abroad, when it is said that duties should be equal to the difference between domestic costs and foreign costs? The marginal producer here and the marginal producer abroad would tend to have identical costs, after allowing for transportation and related items. Furthermore, since goods are often produced as by-products or in conjunction with other goods the difficulties of determining the costs of any particular article or

[5] This philosophy was behind much of the earlier work of the United States Tariff Commission, acting under instructions from Congress. The Commission endeavored to discover costs of production here, and costs of production abroad as a basis for adjusting the rates of duty.

establishment are great, especially in foreign countries. Attempts to determine foreign costs have caused resentment.

The second difficulty with the argument is that trade takes place only because costs (monetary costs in terms of exchange rates) are different in the trading countries. Unless the foreigners' costs, and therefore selling prices, are lower he is unable to sell to us. If a duty were completely successful in equalizing costs (that is, between the highest cost American producer and the lowest cost foreign producer), it would shut out completely the foreigners' goods. A tariff to equalize costs, therefore, means a tariff to make impossible the importation of foreign goods to which it is applied. If foreign goods continue to come in over the tariff, this fact is an indication that the tariff does not equalize costs for everybody. Some foreign producers apparently still have lower costs, after adding the duties, than some of the domestic producers. If the principle of equalizing costs were strictly applied to all commodities, and there is no logical reason why it should be applied to one and denied to another, it would cause a cessation of imports, which in turn would result in a cessation of exports, except such as might be to pay for imports of services or for other debit transactions.

Expanding the Home Market. Another popular argument for a tariff is that by keeping out foreign goods a tariff expands the domestic market for the home producer. It is supposed that a tariff creates an additional market, namely, a greater home market. The slogans "Buy home products," "Buy British," or "Buy American" are based upon this false notion.

Persons who advance this argument fail to understand the give-and-take nature of foreign trade, or of any trade, that exports pay for imports, and vice versa. The foreign transactions of a country must balance, as discussed in Chapter 7, and if imports are curtailed, exports will sooner or later be reduced. If foreigners are unable to sell to us they are unable to get the wherewithal to buy from us. A particular domestic producer may get an additional home market because of a tariff, but he acquires this market at the expense of another producer, an

exporter, who, as a result of the tariff, loses part of his foreign market. The public, moreover, is required to pay a higher price for the protected article produced under less advantageous conditions and at higher costs than the foreign article. The domestic industry which is expanded, and which enjoys a greater home market, is less suited to the country than the industry forced to reduce its foreign market. Labor and capital are withdrawn from the efficient industry and directed into a less efficient industry.

A tariff, in effect, forces two citizens to trade with each other instead of with foreigners. If it were to their advantage to trade with each other they would have discovered this fact without a tariff. It is because cheaper, better, or different goods can be obtained abroad that foreign trade takes place. The foreigner, who has received dollars by selling to us, is at the same time enabled to buy goods from us, so that we do not lose any business.

The tariff question has been explained by Professor Taussig as follows:

> The free trader argues that if the duties were given up and the protected industries pushed out of the field by foreign competitors, the workmen engaged in them would find no less well-paid employment elsewhere. Presumably they would betake themselves to the exporting industries, in which labor is advantageously applied. The protectionist answers that there would then be "overproduction" in those industries, —that more goods would be produced, prices would be lower, and then wages lower. No, replies the free trader,—there would be more goods, but not lower prices or lower wages. For there is a new demand for those exportable goods, *pari passu* with the new supply. Goods are imported which were formerly made by protected industries. The new imports must be paid for by exports; there is a new foreign "market" replacing the lost domestic "market." The eventual result, says the free trader, is that more workmen will be turned to the advantageous industries, and more goods will be exported in exchange for more imports; there will be higher wages (in terms of commodities) all around within the country, resulting from the more productive direction of its labor.
>
> In all this reasoning, the free trader is right.[6]

[6] F. W. Taussig, *Principles of Economics*, I, chap. xxxvi.

Keeping Money at Home. A phase of the argument of saving the home market for the home producer, and involving the same fallacy, is the idea of "keeping money at home." It is presumed that, by spending at home, the money stays at home, and "home" is thereby wealthier. This was part of the philosophy of the mercantilists and involves a confusion of wealth and money.

Money is a means to an end, and more money means more counters for the existing wealth. Money represents a claim to a certain amount of real wealth. If we spend money abroad we are giving the foreigner a claim to some of our wealth in exchange for some of his. The currency of any country cannot ordinarily be spent anywhere but at home, since it is not current in foreign countries. The foreigner, therefore, sooner or later spends our money here. If he fails to spend our money promptly, but holds it idle the effect is to slow down our economic activity and reduce our incomes. If a domestic recipient of our money, however, holds it idle, the result is the same. When we buy abroad we in effect give the foreigner our money in exchange for his. We then spend his money over there and he spends ours over here. The transaction is an exchange of goods for goods consummated by means of money.

This question is similar to that noted above regarding whether we should trade with domestic producers or foreign producers. If trading with the domestic producer costs us a higher price, gives us poorer goods, or entails a sacrifice of some kind, this is an indication that he is a less efficient producer, and that he should not be maintained at the expense of the more efficient. As applied to a particular locality or neighborhood, there are often mitigating circumstances. A person may trade at a neighborhood store even at some sacrifice, since he wishes to have the store continue there as a matter of convenience. Local pride and the desire to see his town flourish —which may perhaps react to his personal interest—may cause a person to buy locally even at a sacrifice.

Increasing the Number of Jobs. It is sometimes argued that tariffs increase the amount of work available for labor.

Workmen are told that if foreign goods are kept out of the country there is that much more work for the American worker. He is needed, the argument runs, in making goods that were formerly imported. On the surface this seems plausible enough, and yet the fallacy is not far to seek. If imports are shut out, exports are also reduced and there is less work in the export industries. Furthermore, the employment of labor is not an end in itself, but the work is performed for the sake of the things produced. If workers are employed in the most productive ways, workers and others have more commodities to consume. The real income of a worker depends more upon how much wealth he is able to produce, than upon the number of hours he puts in during a given time.

Chapter 19

UNITED STATES TARIFF HISTORY—TRADE AGREEMENTS PROGRAM

The tariff issue in the United States has long been intimately mixed with national politics. The agricultural South, especially during the early years of the country's history, had little need for tariff protection, while the manufacturing industries of the North soon discovered that tariffs were useful. This geographical division with respect to interest in the tariff has continued to the present time, but is less pronounced than formerly. The Republican Party of the North has thus sponsored protection, and the Democratic Party of the South, while leaning toward free trade but (with an eye on northern votes) not willing to urge complete free trade, has favored a moderate amount of protection.

American tariff history has until recently been characterized by a tendency toward more and more protection. From about the beginning of the last century until 1930 the country pursued a policy of increasingly high tariffs. Republican administrations commonly raised tariffs, whereas Democratic administrations usually reduced them, but not to their former levels. Since the passage of the first tariff act in 1789 until the Hawley-Smoot Act of 1930, there has been a new tariff on an average of about every seven years. Since 1933 this government has been seeking to reduce the country's extremely high tariffs and has undertaken this through the negotiation of reciprocal trade agreements in accordance with the Trade Agreements Act of 1934. Substantial reductions have taken place as noted below.

American Tariff History from the Revolution to Jackson.—After American independence had been achieved and

while the country was under the Articles of Confederation, the regulation of external commercial relations became the prerogative of the individual states. Partly because of antipathy for the colonial policy of Great Britain, which involved extensive trade restrictions, sentiment in favor of freedom of trade was sufficiently strong during the period of the Confederation to insure the prohibition in the Constitution of interstate trade barriers.

The first Act of Congress under the Constitution levied a tariff on imports, which was primarily for revenue purposes. Most of the separate rates of duty in this tariff, as well as the general average rate, were the lowest ever established by Congress. There was no free list, a 5 per cent rate being imposed on all goods not otherwise provided for.

Interest in protection as a national policy developed rather early in American history. A feeling existed that the source of British wealth and power lay in her efficient manufacturing industries. In 1790 Alexander Hamilton, the young Secretary of the Treasury, was instructed to prepare a report on protection in relation to the development of domestic manufacturing. In 1791 he submitted to the House of Representatives his Report on Manufactures in which he carefully considered the case for and against protection in America. He favored moderate protection in order to facilitate the growth of industries, which in turn he believed would promote national unity. The development of manufacturing industries he thought would aid in achieving a more stable and balanced economy. In addition to advancing the infant-industry argument and that of military self-sufficiency, Hamilton desired to promote an expansion of the domestic market for American agricultural products. He believed that so long as the United States confined its production principally to agricultural products and raw materials, which were to a large extent sold abroad, its prosperity would depend upon the uncertain whims of foreign markets. He therefore advocated the encouragement, through mild protection, of domestic manufacturing. Expansion of domestic industry, he thought, would provide a dependable internal demand for farm produce.

Hamilton favored bounties as a means of aiding industry, and he preferred them to tariffs. Bounties, he argued, are more positive and direct, and do not raise prices or produce a scarcity as do import duties. They also promote exports, which is not true of protective tariffs which in fact may discourage exports if levied upon raw materials used by the export industries.

From the signing of the Constitution in 1789 until 1812, thirteen tariff laws were passed, chiefly for revenue purposes. Many of the rates were gradually increased during this period to obtain larger revenues. Some articles, however, were placed on the free list.

The War of 1812 virtually put an end, temporarily, to the country's previously thriving foreign commerce, trade having fallen in 1814 to less than one-twelfth its former maximum. Tariff rates were therefore doubled in the hope of securing more revenue, but without avail.

When peace returned, imports were resumed on a large scale, and the demand for protection against foreign competition became great. The absence of foreign products during the war had stimulated the growth of domestic manufactures. Accordingly, the Tariff Act of 1816 was adopted, and included protective features, rates being sharply raised on many articles. Judged by later standards, however, this tariff was not high; it largely failed, in fact, to protect industry. Consequently, the Tariff Act of 1824 provided for further increases.

From Jackson to Lincoln.—The Tariff Act of 1828, remembered as the "Tariff of Abominations," was a poorly framed protectionist measure which provided for rate increases on all goods, some rates as high as 100 per cent ad valorem. The tariff was bitterly resented in the South, and leading southern statesmen urged its nullification. The issue contributed to the ill feeling which culminated in the Civil War.

The Tariff of 1832, during the administration of Andrew Jackson, represented a mild downward revision and was an attempt to placate resentment, but the South was by no means satisfied. Since both North and South wished at this time to avoid actual conflict over the nullification issue, the so-called

Compromise Tariff of 1833 was passed, providing for a process of reduction during a period ending in 1842. According to this plan, the reduction in rates was to be small at first, gradually increasing so as finally to bring the maximum rate on any article down to 20 per cent. The 20 per cent rate, however, remained in effect only two months in 1842, being replaced by a distinctly protective Whig tariff which remained in force for four years.

The incoming Democrats in 1846 passed what is commonly referred to as the "Walker Tariff." Although by no means free from protective features, this act established generally lower rates and a less complex tariff system. The Walker Tariff remained in effect for eleven years, during a period in which the country enjoyed considerable prosperity and economic advancement. In 1857, rates were again generally reduced, with a provision that the maximum duty was to be 24 per cent. This reduction took place at the peak of a boom, just prior to the collapse in the summer of that year, and received a share of the blame.

From Lincoln to McKinley.—The Civil War saw a sharp reversal of American tariff policy and a renewal of the clamor for protection. Under the Republican Morrill Act of 1861, which went into effect just before Fort Sumter was fired upon, rates were sharply increased, for admittedly protective reasons. Until the close of the war in 1865, some rates were increased almost every month, with virtually no debate. Rates were raised far above levels previously in effect. The two most important tariff acts of the war were those of 1862 and 1864, the latter raising rates to an average of 47 per cent on a long list of items. In addition to the extensive tariff increases, internal taxes were imposed on many kinds of manufactures in order to increase revenues. These were all regarded at the time as emergency measures.

Like the War of 1812, the Civil War had stimulated manufacturing in the North. Consequently, when the war was over there was a strong demand for continued protection. Inasmuch as the South, which opposed high protection, had lost in political

prestige, it is not surprising that the high wartime tariffs were retained almost completely intact. The actual protection, in fact, was increased by the rapid repeal of the heavy internal excises. Furthermore, the tariff on woolen goods was increased in 1867, to be followed in 1870 by many other increases of a protective nature.

With recovery from the panic of 1873 and the subsequent depression, a growing popular demand for downward revision became evident. The tariff was a leading issue in the campaigns of 1876 and 1880. In response to public sentiment for reduction, the Republican Tariff of 1883 was passed, which, however, was little more than a gesture made by the friends of protection. Some rates were lowered, while others were raised with a protective purpose.

Although President Harrison was elected by a narrow margin in 1888, the Republicans accepted the victory as a mandate for further protection, and proceeded to enact the McKinley Tariff of 1890. It is interesting to note that in the speeches in favor of this act, the infant-industry argument was abandoned, it being obviously irrelevant, and instead the "pauper-labor" argument [1] was substituted. The new law extended protective rates to agricultural products; rates on wool were increased and a bounty was granted to domestic sugar producers, the duty on imported sugar being removed.

The Democratic Party under President Cleveland returned to office in 1893, and the following year the Wilson Tariff Act was passed. While nearly all changes by this law were in a downward direction, the reforms as a whole were not great, and the measure was disappointing to many Democrats who favored tariff reduction. President Cleveland, in fact, allowed the measure to become law without his signature. Most notable among the downward changes of this act was the placing of raw wool on the free list.

The Republicans followed their 1896 victory with the enactment of the Dingley Tariff in 1897, which provided for a steep increase in protective rates. The duty on wool was again

[1] See pages 326-28.

revived, and high rates were levied on silks, linens, woolens, and other articles. The Dingley Tariff remained in effect for twelve years, the longest period for any tariff law in American history until the Hawley-Smoot Tariff of 1930. Because of a steady rise in the commodity price level, the average rates under this act of 1897 tended gradually to become more moderate, inasmuch as specific rates became relatively smaller percentages of values.

Since 1900.—The Republican Payne-Aldrich Tariff of 1909, like the Tariff of 1883, was in response to a demand for downward revision. Like the earlier act it was a revision by the friends of protection. Many changes in rates were made, both downward and upward, but experience under the act indicated that little reduction, if any, had been accomplished. A special feature of the new law was the establishment of minimum rates, with provision for possible imposition of maximum rates, which were to be applied by the President. Provision was made for countervailing duties on foreign articles which had been produced with the aid of foreign government bounties. This provision was in the Dingley Tariff of 1897, and was brought forward without change. The Payne-Aldrich Act was the object of bitter criticism, and became a leading issue in the campaign of 1912.

When the Democrats returned to power under Woodrow Wilson, a reversal of tariff policy was inevitable. The Underwood Tariff Act of 1913 was the prompt result. Among its principal features were: (*a*) a general and marked reduction of rates, (*b*) the substitution of ad valorem for specific rates in many instances, (*c*) considerable additions to the free list, especially of raw materials, and (*d*) the taxation of luxuries and special articles more highly than necessities and plain types of goods. The law had been in operation, however, only nine months when the World War broke out in the summer of 1914. The act was thus never given a real test, although it remained in effect for eight years. The war, by interfering with European industry, gave American manufacturing interests far greater protection than had the much maligned Payne-Aldrich Tariff.

With the return to office of the Republicans after the war, and with the revival of European competition, stimulated by depreciated currencies, an Emergency Tariff Act was passed in 1921 providing increased protection, primarily to agriculture. The Fordney-McCumber Act of 1922 extended this program, including the protection to agriculture which had been severely injured by the collapse in wartime prices, and provided substantial protection to industry. The rates, on the whole, were higher than any which had been levied for many years, being above those of the McKinley Act of 1890, the Dingley Act of 1897, and the Payne-Aldrich Act of 1909.

The Fordney-McCumber measure was superseded in 1930 by the even higher Hawley-Smoot Tariff, the most restrictive in American history. Advances in rates were intended to be prohibitive in many instances. The number of dutiable items was raised from 2,840 in the Act of 1922 to 3,221 in the Hawley-Smoot measure.

The decline in commodity prices between 1929 and 1932 served to make all specific duties more protective than they otherwise would have been. In some cases the resultant increase in the real protection was great. The United States Tariff Commission listed 540 articles on which the duty in 1931 exceeded 50 per cent of the value. On silk hosiery the duty was 60 per cent ad valorem, on wool fabrics it was equivalent to 84 per cent, on clocks 109 per cent, and on onions 148 per cent. In several cases, the duty became more than 200 per cent.

When the Democrats returned to power after the election of 1932, they were pledged to reform the tariff. The Democratic platform of that year claimed that the Hawley-Smoot Tariff had been the occasion for retaliatory action on the part of forty nations. In June, 1934, the Trade Agreements Act was passed as an amendment to the Tariff Act of 1930. The program of tariff reduction which resulted from the enactment of this law is discussed below.

In spite of tariff reductions under the Trade Agreements Act, increased protection in certain instances was afforded by means of import excise taxes, first introduced in 1932. These

taxes, which are imposed only on imports, are identical with tariffs except in name. The increase of these taxes as a substitute for tariffs gave protection to several important articles such as copper, petroleum, coal, lumber, oils, and fats.

Effects of Tariffs on United States Industry.—The effects of the tariff on the development of industry in the United States and on the United States economy in general are not easily assessed. It appears that during the period prior to the Civil War little protection was obtained from the tariff due to the nature of the country's exports. Exports then consisted largely of agricultural and other primary products for which the foreign demand was fairly inelastic. Because of this inelastic demand the tariff tended to improve the terms of trade of this country, and thereby to result in the receipt of larger quantities of imports in exchange for the country's exports, as discussed in the previous chapter. The improvement in the terms of trade, i.e., relatively larger imports quantitatively, probably offset, or perhaps more than offset, on the average the protection accorded by the tariff. Certain individual industries, however, no doubt enjoyed real protection and were stimulated thereby even though industry as a whole received little or no protection.

After the Civil War industry expanded greatly and exports consisted more and more of manufactured articles, for which the foreign demand was more elastic. The effect of the tariff on the terms of trade during this period therefore appears to have been less favorable than formerly, with the result that substantial protection to industry was received.

In summary, the tariff, by restricting imports, probably reduced the total volume of the country's foreign trade below what it otherwise would have been, raised certain individual prices and also the price level as a result of the stimulation of gold imports, encouraged the establishment of certain industries including some not well suited to this country, and had other effects as discussed in the previous chapter.

The United States Tariff Commission.—The United States Tariff Commission was created in 1916 during Woodrow Wilson's administration, with the hope that it would help to

take the tariff out of politics—a difficult assignment inasmuch as tariffs are ordinarily adopted for political rather than economic reasons. It was intended to put tariff-making on a more orderly basis, as opposed to the method of log-rolling and political pressure. The commission was set up as an independent, fact-finding body, authorized to study the problem of the tariff and to make reports.

The commission, altered somewhat in 1930, consists of a bipartisan body of six members—three Democrats and three Republicans—appointed by the President and approved by the Senate. Each commissioner is appointed for a term of six years. The commission employs a staff of experts, and in carrying out its duties is permitted to examine the files of any business concern and to order witnesses from any part of the country to appear, testify, or submit documentary evidence.

The commission in its first years gave special study to foreign tariffs and foreign tariff policies. Some of the material developed by the commission was used in congressional debates, but usually only when it supported desired ends. The commission did not succeed in taking the tariff out of politics, although something in this direction has been accomplished in connection with the Trade Agreements program.

One of the important duties of the Tariff Commission was in connection with the "flexible" provisions of the Tariff Acts of 1922 and 1930. These provisions gave the President power to raise or lower tariff rates, by not more than 50 per cent, whenever the commission determined that duties on a particular article did not equalize foreign and domestic costs of production.[2] The provisions authorized the commission to make studies of production costs at home and abroad when it felt that complaints regarding existing tariff rates were justified and, on the basis of such studies, to make recommendations to the President. Accordingly, the commission made extensive cost-of-production studies in various parts of the world.

[2] Where an increase in rate by 50 per cent was deemed insufficient to equalize costs of production, the Commission was authorized to change the basis of valuation from foreign value to "American selling price"—a method of greatly increasing the amount of the duty without changing the rate.

Many of the cost studies were of little practical value. In the first place, as pointed out in the previous chapter, the cost-equalization principle is fallacious. The very reason for trade is a difference in costs, and if costs were equalized this would remove virtually all occasion for foreign trade. A further difficulty is in the fact that costs vary widely within the same country, and the question arises as to whose costs are to be taken as a basis. Furthermore, foreign nations did not take kindly to having American Tariff Commission investigators study their costs and other data.

Prior to the world depression, the flexible provisions were used principally to raise duties and but rarely to lower them. From the time of the enactment of the Fordney-McCumber Tariff in 1922 to the year 1929, the President proclaimed thirty-seven tariff changes. In only five of these were duties lowered, all the others being increases.[3]

Since the enactment of the Trade Agreements Act in June, 1934, activities of the commission under the flexible provisions have been curtailed. Changes in rates which might otherwise have been made under the flexible provisions have instead often been effected by reciprocal agreements. The Tariff Commission has been particularly active in connection with the trade agreements program, and has made valuable studies of the effects of proposed tariff changes and other matters.[4]

The Trade Agreements Program.—In June, 1934, Congress passed what is known as the Trade Agreements Act, section 1 of which is an amendment to the Tariff Act of 1930. The purpose of the new law was to make possible a program of tariff reductions in return for concessions by foreign nations; the agreements negotiated are thus called "reciprocal trade agreements." The Act grants the President power to make agreements with foreign nations involving alterations in the tariff, without referring the agreements to Congress for approval. This simplifies tariff changes. The President is au-

[3] United States Tariff Commission, Annual Report, 1929, pp. 23-25.

[4] A history of the Tariff Commission's activities during the first twenty years of its existence, 1916-36, is contained in the Annual Report of the Commission for 1936.

thorized to negotiate for reductions in duties and other trade restrictions imposed by foreign countries and to make reciprocal concessions with respect to United States imports.

The President's authority under the act is subject to the following limitations: (*a*) he may not lower or raise duties by more than 50 per cent; (*b*) he may not transfer an article from the free list to the dutiable list, or vice versa; (*c*) before concluding an agreement he must give public notice, in order that all interested parties may have an opportunity to express their views; and (*d*) he must seek the advice of the United States Tariff Commission and the Departments of Agriculture, Commerce, and State and other government agencies. While the President is prohibited from removing any article from the free list, he is authorized to promise a foreign power that an article which is on the free list shall remain there, or to guarantee that an article which is dutiable at a given rate shall continue dutiable at not exceeding that rate. The President may modify without limitation any import restriction which is not a customs duty.

The negotiation of trade agreements was undertaken by the Department of State, under the leadership of Secretary Cordell Hull, and with the cooperation of the Tariff Commission and interested departments. A number of trade agreements were soon negotiated. An example of an important trade agreement of this period is that with Canada, which went into effect January 1, 1936, subsequently revised and supplemented. According to this agreement American products received many specific concessions from Canada, as well as unconditional "most-favored-foreign-nation" treatment, i.e., the lowest rates accorded any nonempire nation.[5] According to the original agreement, over 800 American export commodities were immediately benefited by the most-favored-foreign-nation provision. Twenty

[5] Canada has a three-rate tariff system, providing for minimum, intermediate, and maximum schedules. Minimum rates are available only to nations belonging to the British Empire; conventional or intermediate rates are granted to nations with which trade treaties have been made, while maximum rates apply to others. Unconditional "most-favored-foreign-nation" treatment therefore simply involves the extension of the conventional rates. Prior to the effective date (January 1, 1936) of the Canadian trade agreement, imports into Canada from the United States were subject to the maximum rates.

American export items were transferred by Canada from the dutiable to the free list, and sixty-nine items received special duty reductions below the previous most-favored-foreign-nation rates. On still other articles rates were guaranteed against increase. The decrease in the rates resulting from the agreement, in comparison with rates previously in effect on American goods, ranged in most cases from one-tenth to one-half. In return for these concessions, the United States made tariff reductions which benefited about two-thirds (by volume) of Canada's total exports to this country. Perhaps the greatest favors to Canada were the promises that her most important exports—newsprint, pulpwood, and woodpulp—would be kept on the free list. Subsequent revisions of the Canadian agreement provided for more and deeper reductions.

Trade agreements were negotiated with 28 countries up to 1947, at which time this country entered into a multilateral trade agreement with a large number of countries, discussed below, and ceased thereafter to negotiate bilateral trade agreements. The General Agreement on Tariffs and Trade (GATT) entered into force provisionally in January, 1948, and replaced existing trade agreements between the United States and some of the countries parties to the General Agreement. Negotiations under the General Agreement for further reductions have taken place from time to time with the original participating countries or with newly participating countries.

With two exceptions the trade agreements program has been based on the principle of equality of treatment, whereby any trade concessions granted by this country to a particular foreign country are automatically extended to all countries, whether or not the United States has most-favored-nation treaties with them. The two exceptions are: (1) Cuba and the Philippines, with which this country has long had preferential arrangements, and (2) nations which are found by the President to discriminate substantially against products of the United States. It has been proposed, however, that the United States grant concessions only to countries which are participants in the General Agreement. This principle of equality of treatment does not prevent tariff bargaining inasmuch as the United States ne-

otiates a tariff reduction with the principal suppliers of a par-icular commodity.

The authority of the President to enter into trade agreements under the original Trade Agreements Act of 1934 was to re-nain in force for three years. It has been extended periodically or varying periods and with some alterations. In 1945 the 50 per cent permissible change in duty was made applicable to the hen existing duties, rather than the original 1934 duties. The extension of the Act has been strongly opposed. Efforts have been made to insert crippling amendments such as a requirement hat all agreements be submitted to Congress for approval, and on some occasions such amendments have been defeated by a small margin.

The so-called "peril points" clause which is included in the 1951 two-year extension of the Act provides that if the President educes a tariff to a point which the Tariff Commission considers nvolves serious injury or a threat of serious injury to a domestic ndustry, he must report to Congress his reasons for so doing. While the provision may appear on the surface to be innocuous t tends to handicap the trade agreements program and by com-plicating procedures makes more difficult the reduction of ariffs. The 1951 extension of the Act also requires that future rade agreements contain a so-called "escape clause" which has been inserted in certain recent agreements by the President. The escape clause provides that either party to the agreement nay withdraw or modify a tariff reduction in the event that the eduction causes or threatens to cause serious injury to a do-nestic industry.

Opposition to extension of the Act has been severe each time the Act comes up for renewal. Certain industries have desired that the government shield them against foreign competition. Experience under the Act, however, has failed to reveal cases of naterial damage to any American industry. The United States nas endeavored to avoid tariff reductions which involve serious narm to any segment of American industry.

Further Tariff Reduction.—The large export surplus of the United States in the years immediately following the second

World War, and the problem of the "dollar gap" or "dollar shortage" focused attention upon the tariff and other barriers to imports into this country. The urgent and strong demand of war-devastated countries for United States goods, and a similar demand from other countries that had been unable to buy during the war led to unprecedentedly large exports from the United States after hostilities had ended. Inflated incomes in many countries contributed to the strong demand for United States goods. Latin America and other countries that had accumulated dollars during the war were for a time able to pay for their large imports by drawing down these accumulated holdings. Europe's demand, greatly in excess of what Europe could pay for by exports from depleted production, was financed by grants and loans from the United States Government and by drawing on such dollar assets and gold as were available to these countries.

In view of the large excess of exports the United States was confronted with the necessity of choosing between (*a*) continued financial aid to Europe and other foreign countries in order to provide them with the dollars needed to pay for their large purchases in the United States, (*b*) an increase in United States imports (or in other dollar debit transactions such as the export of United States investment capital) so that foreigners could earn more dollars, or (*c*) a reduction of United States exports, with depressing effects upon United States agriculture and industry. As these alternatives became clearer to the American public, efforts to increase imports and to this end to reduce the country's tariffs received special attention.

One of the methods to facilitate imports that was sponsored by the administration was a revision and simplification of customs procedures. Customs practices and procedures had long been onerous and a deterrent to imports. In addition to burdensome paper work required, rates of duty were often undeterminable by importers until an import was actually made and the goods classified; sometimes the rate would not be finally determined until months or even years after the goods had been sold. Methods of valuation varied and might be "foreign value," "export value," "United States value," "cost of production," or "American selling price." In 1947 Congress provided

the Treasury Department with a special fund to study the possibilities of customs simplification. Government agencies and private groups were consulted and in 1950 a bill was introduced in Congress under Treasury sponsorship to implement some of the proposed customs reforms, without, however, seeking to alter rates of duty. Certain changes did not require legislation and a number of these were put into force administratively.

Although a reduction of the excess of exports has come about through increased imports as a result of the rearmament program, and a diversion by foreigners of more of their purchases to markets other than that of the United States (following restoration of production and adjustments of exchange rates) with a resulting decline in United States exports, the need for a lowering of United States import barriers still remains for reasons discussed in the preceding chapter. Protective import duties, particularly the higher duties, are in general not in harmony with this country's foreign economic policy, especially its sponsorship of the objective of a nondiscriminatory, multilateral trading system, free from restrictions not justifiable on economic or other essential grounds.

It has been urged that the time has come for a bold attack on this country's tariff and that a strengthened Trade Agreements Act is needed which would make possible further and deeper tariff reductions, especially of some of the exceptionally high rates of duty. Rate reductions, for example, that the President is authorized to undertake might not be limited to 50 per cent of the duty, so long as an unduly large inflow of the commodity does not result. It has also been suggested that the United States should reduce rates unilaterally without waiting for concessions from other countries. On the other hand, it is argued that while such unilateral reductions would be beneficial to this country, they would not make use of the bargaining power involved in a *quid pro quo* program to obtain a general lowering of trade restrictions by other countries.

It has been suggested that in order to reduce some of the higher rates of duty, Congress should provide that no rate shall be in excess of, for example, 75 per cent of the value of the

commodity. This ceiling would apply whether the duty were ad valorem, specific, or a combination of the two types as is frequently the case. Such a measure would remove the obscurity surrounding some of the rates whose height is concealed by methods of calculation.

It has also been suggested that even though certain tariff reductions may harm some industries, the reductions should nonetheless be undertaken. To the extent that industry is damaged by tariff reductions, the government should, it is said, endeavor to relieve the burden inasmuch as by its tariff policy the government has encouraged capital to go into the protected fields. A special subsidy or perhaps some other form of aid might be given an industry when the evidence of damage is clear, such subsidy to be temporary and designed to provide an opportunity for readjustment to other types of production. Furthermore, certain types of specialized labor such as that in watch-making, hand-blown glass, and gloves, might be damaged by drastic tariff reduction, and therefore might appropriately be aided by the government when injury was clear. A subsidy or aid program, it is said, would be less costly to consumers than paying high prices for imported goods and being deprived altogether of certain imports. One of the drawbacks of such a proposal is the difficulty of judging the damage, if any, attributable to tariff reduction. With market conditions constantly changing it would not be easy to determine accurately the loss due to reduction of a particular duty. Certain tariff students believe that the contribution of the tariff to the profits of United States industry is commonly overestimated, that if tariffs were completely swept aside the damage to the affected industries would not be great, and that only a few marginal producers would be seriously harmed.

It has been suggested that rates of duty be reduced gradually. If rates were to be lowered gradually according to a schedule involving a certain percentage a year, over a period of perhaps five or ten years, such damage as might occur might be minimized and in many cases would be nonexistent. The schedule could be adjusted to the nature of the particular industry and to the height of the duty. The speed with which such

reductions could be accomplished would depend in part upon the amount and adaptability to other uses of the capital invested in an industry, and also upon its rate of depreciation and obsolescence. If the capital is subject to a high rate of depreciation and obsolescence, or can readily be converted to other purposes the period of tariff reduction can be short. Moreover, if an industry requires relatively little capital any loss from tariff reduction is less than if much equipment, especially elaborate and specialized equipment, is necessary. In the United States industry is dynamic and is constantly expanding and changing. New processes are introduced and new equipment installed. Labor, with relatively few exceptions, is continually shifting from one job to another, and were it not for replacements the labor force would soon be reduced from voluntary withdrawals. Under such conditions of change and expansion, tariff reductions should offer no serious economic difficulties. From the standpoint, however, of practical politics and opposition from affected producers, the problem is different.

The United States since 1934 has made substantial progress in freeing its imports from some of the previously existing excessively high rates of duty. It has reversed its historic course of higher and higher protective tariffs, interspersed with a few relatively small and short-lived reductions. These more recent actions are consistent with this government's belief in free enterprise, competition, and nondiscriminatory multilateral trade, and its desire to promote an expansion of production and to improve living standards in all countries. The problem of the United States tariff is, nevertheless, not yet solved and will no doubt continue for a considerable period of time.

Chapter 20

TRADE POLICIES—GENERAL AGREEMENT ON TARIFFS AND TRADE

United States Proposals for Expansion of World Trade and Employment.—While the second World War was still in progress the United States Government gave considerable attention to the economic and financial conditions which would be likely to exist in the postwar period, and to the kinds of policies and procedures which it believed should be followed in the interests of all countries. Article VII of the Lend-Lease Agreements entered into between the United States and many countries provided for "agreed action . . . open to participation by all other countries of like mind, directed to the expansion, by appropriate international and domestic measures, of production, employment, and the exchange and consumption of goods, which are the material foundations of the liberty and welfare of all peoples; to the elimination of all forms of discriminatory treatment in international commerce; to the reduction of tariffs and other trade barriers." [1] The United States believed that the nations should agree on a body of principles and rules of conduct which would guide them in their economic and financial relations with each other, and that there should be established international organizations to provide continuous consultation, to assure observance of the agreed standards, and to assist in other ways in the attainment of the objectives.

At the United Nations Monetary and Financial Conference which met at Bretton Woods in 1944 to complete plans in the international financial field, it was recognized that the plans worked out there for the International Monetary Fund were by themselves inadequate to attain the purposes of the Fund.

[1] For the full article see Chapter 34.

These purposes included, "to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy." Tariffs and other restrictions on trade interfere with realizing these fundamental objectives. A resolution was accordingly adopted by the conference which recommended that the nations agree on ways and means to "reduce obstacles to international trade and in other ways promote mutually advantageous international commercial relations." International action in the field of trade and related matters, to parallel that being taken in the field of finance, was thus contemplated for the near future even prior to the establishment of the United Nations Organization.

United States thinking regarding the kind of international economic policies and relations which should prevail after the war and the means of achieving these objectives, were set forth in a publication entitled "Proposals for Expansion of World Trade and Employment," issued by the State Department in November, 1945. These Proposals, which dealt primarily with nonfinancial matters, while presented as a basis for discussion rather than as official government views, represented the considered opinion of this government's technical experts with respect to fundamental principles and the most promising procedures for achieving a world-wide expansion of production, trade, and a stable level of economic activity. The covering letter by William C. Clayton, Assistant Secretary of State, said: "Powers of production are now the greatest that the world has known. To bring them into play requires agreement on principles of exchange and distribution which will permit trade, production, employment, and consumption all to expand together."

The Proposals recognized four general fields requiring joint or intergovernmental attention. These were (*a*) governmental restrictions on trade, (*b*) restrictions of a private nature especially those imposed by cartels and monopolies, (*c*) postwar transitional adjustments in the production and trade of primary

commodities, and (*d*) cyclical fluctuations in production and employment.

The Proposals contained concrete recommendations for dealing with these problems, and set forth the principles and main provisions which the United States believed should be incorporated in the charter of an International Trade Organization. One of the main objectives of the Proposals was the reduction of tariffs and other barriers to foreign trade, and the elimination of discriminations in such trade. It was envisaged that members of the proposed Organization would enter into negotiations to accomplish these objectives. The United States would be able to participate in such negotiations for tariff reductions under the authority of the Trade Agreements Act. The Organization would take its place alongside of other specialized agencies affiliated with the United Nations such as the Food and Agricultural Organization, the International Monetary Fund, etc.

Economic and financial discussions took place in the latter part of 1945 between British and United States officials covering major questions such as possible financial assistance from the United States to the United Kingdom, settlement of lend-lease obligations, commercial policies including the fields of trade barriers and discriminations, commodities in surplus, cartels, and international aspects of measures to maintain employment. At the end of these discussions a joint statement was issued by President Truman and Prime Minister Attlee which referred to the Proposals that had been issued by the United States and said in part: "Equally, the Government of the United Kingdom is in full agreement on all important points in these proposals and accepts them as a basis for international discussion; and it will, in common with the United States Government, use its best endeavors to bring such discussions to a successful conclusion, in the light of the views expressed by other countries." [2] The Proposals were also discussed by the United States with other governments.

Proposed International Trade Organization.—The Proposals recommended that there be held promptly an Inter-

[2] Anglo-American Financial and Commercial Agreements. Department of State publication 2439, Commercial Policy Series 80, December, 1945.

national Conference on Trade and Employment under the sponsorship of the United Nations. In February, 1946, at its first meeting, the Economic and Social Council of the United Nations called such a conference and arranged for the meeting of a Preparatory Committee, which met in London later that year, to draft a charter for the proposed International Trade Organization. At this meeting the United States presented a draft charter which it had prepared and which was used as a working paper. A second session of the Preparatory Committee met in Geneva in 1947, and completed its draft of the proposed Charter. The United Nations Conference on Trade and Employment met in Havana in November, 1947, participated in by 57 countries, and in March, 1948, completed its final draft of what became known as the Havana Charter.

This charter contained important changes over that initially proposed by the United States. It was a more complicated document and in several respects weaker and less satisfactory from the standpoint of freeing trade from burdensome restrictions, discriminations, and facilitating an expansion of world trade and production. It was, however, the best that could be agreed upon by the nations represented at the conference. It was designed as a comprehensive code or set of rules of conduct and policies with respect to international trade.

The United States Congress did not accept the charter of the International Trade Organization, drawn up at the United Nations Conference on Trade and Employment in Havana in 1948, and the proposed organization never came into being. The charter, nevertheless, merits study since its important commercial policy provisions are embodied in the General Agreement on Tariffs and Trade which came into provisional operation in 1948. The charter also reflects the views, often conflicting, of a large number of countries, and represents the agreement with its exceptions finally reached by the negotiators of these countries with respect to a variety of international economic subjects.

The main objective of the charter was to establish a system of world trading on a multilateral basis free from hampering restrictions and controls, except such as may be necessary to meet special situations. The charter recognized that maximum

production and trade are possible only when trade is reasonably free to flow to the best market wherever that may be, rather than be confined by bilateral arrangements or channeled according to political or other considerations. The goal was a broad multilateral and relatively free system of trading. To this end the charter sets forth principles and rules of conduct which were to be observed by members of the proposed Organization, the ITO as it was to be known.

The principal provisions with respect to trade are contained in the articles in Chapter IV of the charter, which chapter deals with commercial policy. These articles provide in general for equal treatment among all members, i.e., unconditional most-favored-nation treatment, with respect to customs duties and procedures. Existing tariff preferences may be continued but the preference differentials may not be increased, and members must undertake negotiations for the elimination of such preferences. Other discriminations must be abolished. The principal existing preferences which according to these provisions are exempted are those between countries of the British Empire, and between the United States and Cuba and the United States and the Philippines.

With respect to the major question of tariff reduction the charter provides that members shall enter into negotiations for the substantial reduction of their prevailing tariffs. Tariff bargaining among the member countries is contemplated wherein each country bargains individually with other countries on articles of which each country is an important supplier. This type of bargaining was conducted successfully in Geneva in 1947 among a number of countries as noted below. The United States at that time negotiated tariff reductions with 22 countries, a number of which also negotiated with each other. The charter provides that whatever reductions are accorded to one member are extended automatically to all other members of the ITO.

The charter endeavors to prohibit entirely the use of quantitative restrictions on trade, namely the fixing of quotas or amounts of specific commodities that may be exported or imported during a certain period. Quantitative restrictions, par-

ticularly on imports, were applied in the years prior to the second World War and grew rapidly in extensiveness until by the time of the Havana Conference they had become a serious barrier to trade. Tariffs were no longer the principal means of restricting imports in many if not most countries of the world other than the United States. The aim of the charter in banning the use of quantitative restrictions was to simplify the restrictions on trade through the elimination of almost all types but tariffs, and then to provide for the reduction of these. This aim, however, was not completely attainable inasmuch as several countries were unwilling to forego entirely the use of quantitative restrictions. Certain exceptions were therefore allowed. The charter as finally drafted establishes a general prohibition on the use of quantitative restrictions except under certain defined circumstances. Exchange restrictions, although a serious barrier to trade, are not dealt with in the charter inasmuch as these were provided for in the Articles of Agreement of the International Monetary Fund drawn up at Bretton Woods.

The major exception to the prohibition on quantitative restrictions is when a country is in balance of payments difficulties. Quotas thus may be applied by a country "to the extent necessary

"(i) to forestall the imminent threat of, or to stop, a serious decline in its monetary reserves, or

"(ii) in the case of a member with very low monetary reserves, to achieve a reasonable rate of increase in its reserves." [3]

The charter gives the International Monetary Fund authority to assess the condition of a member's monetary reserves in connection with the above provisions. In view of the continuing balance of payments difficulties or threat of such difficulties in many countries, this exception is of considerable significance. It was criticized as opening the door fairly widely to the application of quantitative restrictions. However, it shut the door part way even though not fully. British and other representatives were insistent that exceptions of this nature be inserted.

[3] Article 21.

A further important exception to the general prohibition on the use of quotas is in the case of a country which desires to provide protection for a new industry, but such use requires a case by case approval in contrast to the exception for balance of payments reasons. The underdeveloped countries represented at Havana feared that the charter might be used to hinder their industrialization by preventing restrictions to aid new industries. They therefore insisted that such an exception be included.[4] The charge was made that the advanced countries with well-established industries were endeavoring to protect their markets against potential competition from the underdeveloped countries. There was, however, little basis for this charge.

Another exception to the ban on quotas is in the case of the importation of agricultural products where the domestic supply is subject to government restriction. Quotas may be used in such cases under certain conditions to prevent imported products from interfering with the support program. If quotas are utilized, however, they must not be employed as a protective device to increase the portion of the home market supplied by domestic producers. Export quotas are permitted in the case of a critical domestic shortage of food or other essential product.

When quantitative restrictions are utilized the charter endeavors to see that they are applied in general in a nondiscriminatory manner. The quotas allocated to the different countries are generally to be based upon the proportions of the commodity supplied by these countries during a previous representative period, with due account of special factors. A member may, nevertheless, depart from the rule of nondiscrimination in order to utilize holdings of inconvertible currencies. If a country, for example, has a large supply of certain inconvertible currencies, but lacks dollars, it may in the allocation of import quotas among the different countries discriminate against the United States and in favor of the countries whose inconvertible currencies it holds. These discriminatory privileges are eventually to be eliminated, i.e., at the end of the postwar transitional

[4] A number of conditions and limitations to the use of this exception would in practice tend to limit resort to it to a few cases.

period as determined for each country by the International Monetary Fund.

In spite of the provisions regarding nondiscrimination members may form customs unions or free trade areas. In a free trade area trade barriers between the members are substantially eliminated. In a customs union in addition to such elimination of trade barriers the members apply the same duties to imports from outside countries. It was recognized that the establishment of a customs union or free trade area may require a certain amount of time, so the charter permits its establishment by stages. The transitional arrangements, however, must be approved by the ITO so as to make sure that a complete union is accomplished within a reasonable period of time and that the program is not merely a discriminatory arrangement.

In addition to these commercial policy provisions, which are incorporated in the General Agreement on Tariffs and Trade, the charter also deals with restrictions on trade imposed by cartels and monopolies. To remove government restrictions on trade but to permit private restrictive practices would be to deal incompletely with the problem. In order to eliminate restrictive business practices, insofar as possible, the charter requires members to take appropriate measures with respect to those practices affecting international trade, which restrain competition, limit access to markets, or foster monopolistic control, whenever such practices have harmful effects. The charter lists such practices, and provides for consultation for their removal by the country concerned. The Organization may recommend remedial action and require a report on actions taken by such country.[5]

In order to prevent the abuses which have frequently been involved in commodity agreements, particularly those which have to do with a limitation of sales in disregard of consumers interests, the charter establishes certain standards and safeguards against such abuses. It recognizes that in the case of primary products persistent disequilibrium between production and consumption may exist, and that fluctuations in the supply and demand of such products may lead to excessive price de-

[5] See Chapter 33, "Cartels."

clines and distress to producers. In the case of agricultural commodities it is not uncommon that a large number of people are harmed by price declines and maladjustments. At the same time measures taken in connection with efforts to relieve these conditions, such as export subsidies, may have harmful effects upon international trade and upon other countries. Commodity agreements that regulate prices and production, or that impose restrictive controls on exports or imports may be entered into by members of the ITO only in the case (*a*) of a burdensome surplus threatening hardship to many small producers, or (*b*) widespread unemployment arising out of persistent maladjustments which would not be corrected by market forces in a reasonable period of time without causing undue hardship to workers. Commodity agreements must be limited to an initial period of not more than five years (renewable) and must be accompanied by provisions seeking to remedy the maladjustment. Countries which are principal consumers of a commodity must be given a voice in the agreement equal to that of the producing countries.[6]

The charter contains provisions intended to encourage the flow of private investment in the interests of economic development and other objectives. Some of the underdeveloped countries were unwilling at Havana to agree to specific assurances of equitable treatment of a kind that in the eyes of the business world would give confidence to investors. The provisions finally drafted state that "no Member shall take unreasonable or unjustifiable action within its territory injurious to the rights or interests of other members in the enterprise, skills, capital, arts or technology which they have supplied."[7] The charter continues "A Member has the right: (i) to take any appropriate safeguards necessary to ensure that foreign investment is not used as a basis for interference in its internal affairs or national policies; (ii) to determine whether and to what extent and upon what terms it will allow future foreign investment; (iii) to prescribe and give effect on just terms to requirements as to the ownership of existing and future investments; (iv) to pre-

[6] See Chapter 32.
[7] Article 11.

scribe and give effect to other reasonable requirements with respect to existing and future investments." [8] The charter also provides that upon request a Member would undertake the negotiation of a bilateral or multilateral agreement to facilitate foreign investment. Some of these investment provisions of the charter were disliked by American business groups which opposed approval of the charter.

The Organization itself was to be administered by a general Conference consisting of all members, each with one vote. In addition to the Conference there was to be an Executive Board of eighteen members, elected by the Conference every three years by a two-thirds majority, which must include the eight members of chief economic importance, selected with particular reference to their share in international trade. Such members of chief economic importance were to be determined by the Conference every three years by a two-thirds vote, under rules which assured a permanent seat on the Board for the United States.

The consultative features of the Organization are especially significant. The Organization was to provide machinery for regular consultation by member governments with respect to the matters within its province. An individual member was assured that it would be consulted before certain actions that may adversely affect its interests were taken by other members. A member could, if it wished, bring problems up for open discussion and public scrutiny thereby calling on the forces of public opinion to aid its case.

The enforcement powers of the Organization were to be of two general types. In the case of an offending member which failed to conform to the agreement, the Organization had authority to release other members from their obligations under the charter to such member. These obligations could be of substantial benefit to such offending member. The Organization also could bring pressure on an offending member through the forces of open discussion and public scrutiny of a charter violation.

[8] Article 12.

The difficulties encountered in the prolonged charter negotiations in London, Geneva, and Havana, and the differences in the final draft compared with the draft proposed by the United States reveal the differences in fundamental philosophy among the countries at Havana regarding the kind of economic system and international economic relations which should prevail. A number of foreign countries, particularly the United Kingdom, placed great confidence in the efficacy of extensive controls to accomplish major economic and social objectives, and in the ability of government to plan and administer in considerable detail the country's economic activities. At the time of the Havana conference the British postwar Labor Government was vigorously pursuing its policy of substantial socialization and government regulation as a means of elevating living standards. It and other governments were confronted with difficult problems of reconstruction and economic readjustment. Extensive government controls which had done such good service during the war seemed to them an appropriate solution to their problems.

The United States, on the other hand, believed that a minimum of restrictions and controls should be the rule if the world was to enjoy in full a healthy and expanding trade and higher standards of living. The United States was therefore endeavoring to clear away what it regarded as a clutter of barriers and repressive measures which retarded the growth of trade and production, so as to release the powerful productive forces of free enterprise and competition. Such controls as may be employed, the United States believed, should be only those genuinely needed.

The result of these differences of viewpoint was a compromise in that while the charter rested on the main premise of the desirability of free enterprise, reasonable competition, and multilateral trade, a number of escapes and exceptions were introduced. It was the escapes and exceptions which many persons in the United States felt seriously weakened the charter and that were largely responsible for its failure to receive United States approval. The charter represented in a sense the least common denominator among the negotiating nations, which is

always a problem in drafting a multilateral document. Nevertheless the charter represented a body of standards and rules of conduct which many persons believed would have been of material help in the attainment of the ultimate economic objectives which all parties desire.

General Agreement on Tariffs and Trade.—The General Agreement on Tariffs and Trade, commonly referred to as GATT, is a multilateral agreement negotiated in Geneva in 1947 between 23 countries or Contracting Parties as they are called. It came into provisional operation early in 1948. It was negotiated in conjunction with the meeting of the Preparatory Committee which was engaged in preliminary drafting of the ITO Charter, and by the same countries as constituted this Committee.

The General Agreement provides for substantial reductions in tariffs and other trade barriers by the participating countries. The Agreement also contains general provisions regarding commercial policies and procedures, and establishes an internationally accepted code of fair treatment in commercial relations. It deals with such matters as quotas, preferences, internal controls, customs regulations, state trading, and subsidies. Its provisions are substantially identical with those of Chapter IV (Commercial Policy) of the ITO Charter and were put into force, insofar as possible under existing legislation, pending the coming into operation, as was then anticipated, of the charter and the International Trade Organization.

The tariff reductions brought about by GATT apply to products which account for approximately two-thirds of the import trade of the negotiating countries and about half of total world imports. Certain duties are eliminated entirely, others are reduced and others are bound at existing levels. Duty free treatment of some commodities is bound. Tariff preferences have been in many cases either reduced or eliminated. No new preferences may be created and no existing preference differentials increased. Each party to the Agreement is entitled to all of the concessions extended to other parties to the Agreement. This uniform application of all tariff reductions to all parties is

a significant advantage and obviates negotiations by each country on a long list of products, with respect to many of which the particular country is not a principal supplier.

The tariff concessions in the General Agreement were initially negotiated bilaterally on a product by product basis, each country negotiating with the principal supplier of a particular commodity which it imports. The concessions so negotiated were then combined into the schedules set forth in the Agreement and which apply to all of the countries.

The United States participated in the negotiations under the authority of the Trade Agreements Act of 1934 as amended. The General Agreement has replaced all of the Reciprocal Trade Agreements which the United States had previously negotiated with a number of the countries now parties to the General Agreement. Supplementary bilateral agreements were concluded by the United States with such countries providing that the existing trade agreements would either be inoperative for such time as the two countries were both parties to the General Agreement or completely terminated. Trade Agreements, however, between the United States and countries not parties to the General Agreement, such as Argentina, were, of course, not replaced by the General Agreement.

The General Agreement came into force provisionally [9] January 1, 1948, between the United States and eight other countries, including the United Kingdom, France, and other large countries, and soon thereafter with many others. Since then additional countries have acceded to the Agreement from time to time so that as of July, 1951, thirty-one countries were parties to the Agreement and seven others were in the process of acceding.

The General Agreement did not provide for any continuing organization or secretariat, which has been somewhat of a handicap, but the Contracting Parties have held meetings from time to time, and the Agreement has been revised as occasion

[9] Provisional application means to the fullest extent not inconsistent with existing legislation, and that the participating countries may withdraw on 60 days' notice. Certain provisions require legislative action, varying from country to country.

demanded. At some of these meetings additional tariff reductions have been negotiated. At Annecy, France, in 1949, and at Torquay, England, in 1950-51, extensive further reductions were thus negotiated, participated in by newly adhering countries.

In the negotiations at Torquay, which were concluded in April, 1951, over 200 negotiations took place between pairs of countries among the 34 participating countries. (All but four of the 31 parties to the Agreement took part in the negotiations as did seven countries in process of accession.) A total of 147 bilateral agreements were completed, the concessions granted in these agreements applying to all members of GATT. The United States completed negotiations for concessions with 17 countries. The concessions negotiated at Torquay remain in effect at least until January 1, 1954. Similarly, the concessions granted at the earlier conferences at Geneva and Annecy, subject to changes made at Torquay, were prolonged at least until January 1, 1954.

While substantial progress was made at Torquay in the reduction of barriers to world trade, negotiations between the United States and the United Kingdom did not result in an agreement. Nor was the United States able to complete agreements with Australia, New Zealand and South Africa, although an important agreement was completed with Canada. The unsolved problem was that of British imperial preference.

The meeting of the Contracting Parties at Torquay adopted a code of standard practices for the conduct of foreign trade, particularly with reference to the administration of exchange controls. For example, the code provides that a new restriction should not apply against goods actually en route when the change was announced, and that the grant of an import license should imply that the necessary foreign exchange will be obtainable if applied for within a reasonable time. If the code is observed by governments it should assist in the conduct of foreign trade.

The provisions of the General Agreement on Tariffs and Trade are practically identical, as already noted, with the commercial policy provisions of the ITO Charter, which were dis-

cussed above. A discussion of the provisions of the Agreement need not be repeated here. The Agreement represents a notable accomplishment in intergovernmental cooperation in the effort to reduce trade barriers and to promote a world-wide expansion of trade and production on a liberal multilateral basis.

Chapter 21

TRADE AND PAYMENTS AGREEMENTS—STATE TRADING

Government Participation in Trade.—Governments, in recent years, have come to play an increasingly significant role in the field of international trade. Government actions have long influenced foreign trade, usually indirectly as through tariffs or fiscal measures, but until the last two decades seldom did government seek to exercise more or less complete control over the volume, nature, and direction of trade. The introduction of exchange restrictions, multiple exchange rates, quotas on quantities which may be imported and exported, and import and export licensing requirements have enabled governments to exercise a high degree of control over all phases of international trade.

In addition to these devices, discussed in other chapters, governments engage directly in importing and exporting, and other types of international commercial activities such as shipping or aviation. The border line between direct and indirect government trading operations is sometimes tenuous. Governments may make all arrangements for certain transactions, and even provide the financing, but leave the actual conduct of the trade to private parties, whose profit may be largely determined by the government. The active participation of governments in international trade, directly or indirectly, developed largely during the last half of the 1930's and especially during and after the second World War. It accompanied the development of so-called administered or mixed economies.

During the great depression when international trade declined drastically, governments undertook trading operations or arranged for trade in the endeavor to get trade flowing. Ar-

rangements worked out between governments sometimes provided for the actual bartering of certain commodities against each other, but more frequently provided for the establishment of credits in favor of the respective countries, to be used for the import and export of specified commodities. The trade, when it took place, liquidated the credits that had been established. If this bilateral trade did not itself balance, one of the countries would then have a credit balance which could subsequently be liquidated by further trade, or perhaps would be settled by a payment in gold or foreign exchange. Sometimes a portion of the commodities shipped were used to pay off previously existing debts. These arrangements did not necessarily involve the governments in actual buying and selling operations since private traders were frequently used to carry out the shipments under the agreement.

The war gave an impetus to the international trade activities of governments, including direct government trading operations. During the war practically all international trade was either carried on by governments or was strictly controlled by governments with respect to its amount, nature, and direction. When the war was over governments continued their trading operations and also their rigid control over private trade. The shortages of foreign exchange, the disruption of production and transportation, and the scarcity of particular commodities made necessary the extensive intervention of governments in trade and other economic activities.

In Western Europe and in other parts of the world, as reconstruction progressed, there was a gradual return of most trade to private channels, and a relaxation of some of the controls. In the socialized countries of Eastern Europe, however, under Russian domination, the trend was in the opposite direction. The United States endeavored to encourage insofar as possible a world-wide return of trade to private hands, consistent with this country's belief in the advantages of the free enterprise system. In the Western countries, however, the strength of the socialist philosophy, which favored a large sphere for government production and other economic activities, resulted in a tendency for governments to retain a large measure

of the activities acquired during the war. The continuing effects of wartime dislocations also contributed to a retention of controls and government operations. The reluctance of governments to take the steps necessary to balance their international accounts, such as an exchange rate adjustment or the checking of inflation, tended to perpetuate trade deficits and thus to result in a continuation of government activities. The threatening and uncertain international situation was a factor in the same direction.

Trade and Payments Agreements.—One of the principal means through which governments regulate or determine trade is the trade or payments agreement. Trade and payments agreements, sometimes referred to as clearing agreements, were developed initially as a substitute for or supplement to multilateral trade privately conducted. This development took place largely as a result of the depression of the 1930's when trade became dislocated by payments problems. Governments, as noted above, sought means of keeping trade flowing. Surpluses of certain commodities and idle or semi-idle plants, existed in most countries, and led to attempts to devise means whereby these surplus commodities could be traded against similar surpluses in other countries. Accordingly, various direct barter arrangements were worked out. The principal device to fill the void, however, was the payments or clearing agreement.

In these agreements the two contracting governments would establish lines of credit for each other at their respective central banks or monetary authorities, covering trade of certain commodities between the two countries. The commodities would be those which would otherwise not be likely to move, or at least in adequate volume. An importer buying goods from the other country, according to the agreement, would not need foreign exchange but instead would pay local currency into his own central bank. Similarly, an exporter selling goods to the other country would be paid in his currency rather than in foreign money. The local currency paid into the central bank by the importer would be paid out to the exporter. At the end of the period the clearing accounts in the two countries would

probably show a net credit in behalf of one of the countries, since the trade would ordinarily not exactly balance. A net credit which remained in the account in country A in favor of country B might subsequently be wiped out through additional commodity deliveries from A to B, or through payments in gold or other foreign currencies. Most likely it would be carried over into the next period for liquidation.

Through these clearing arrangements efforts were made by the various governments to balance their trade with individual countries. Balances were sought bilaterally as between pairs of countries. Multilateral clearing accounts, however, were sometimes established, notably by Germany in Berlin in terms of marks. A country that earned a net credit from exports to Germany might use this credit for purchases in a third country. This system resembled in certain respects the sterling area system of clearing, but was on a smaller scale and more circumscribed as regards use of the proceeds from current trade.

The trade and payments agreements which have been utilized so extensively throughout the world since the end of the second World War are essentially the same as those described above. The agreements currently in use ordinarily contain a list of quotas for certain commodities that are available for trade between the two countries. They provide that import and export licenses will be issued for trade in such commodities up to specified amounts. The actual trade then takes place largely or entirely through private channels, except in the case of countries where state trading prevails. If a net balance remains at the end of the period additional shipments may be licensed, or settlement may be made in gold or United States dollars. The agreements commonly require periodic settlement in gold or dollars of any net balances over and above the specified credits which, according to the agreement, are established in each others' favor.

As an illustration of the nature of these agreements, a trade and payments agreement concluded recently between Italy and Belgium provided for trade in a long list of commodities specified as to volume and type. The trade was to be denominated in Belgian francs, and a credit margin of 100 million francs was,

according to the agreement, opened by the Italian Foreign Exchange Office with the National Bank of Belgium. The agreement provided that any debt in excess of this margin was to be settled at the request of the creditor country in gold or in other currencies of its choice at the exchange rates established by the International Monetary Fund. At the expiration of the agreement any remaining balance must be settled within one year.

The terms and precise provisions of trade and payments agreements vary according to circumstances, particularly as to the commodities but are essentially alike in their general characteristics. A recent trade agreement between Finland and Denmark, for example, provided for Finnish exports of timber, newsprint, etc., totaling 180 million Danish crowns, and imports into Finland from Denmark of machinery, textiles, etc., totaling 150 million Danish crowns, the difference of 30 million crowns to be applied toward Finland's indebtedness to Denmark from previous trade transactions. An agreement between Yugoslavia and Paraguay provided that the specified trade be in terms of United States dollars, and that at the expiration of the agreement (effective for two years) any balance be settled in goods to be delivered by the debtor country within six months.

Governments also sometimes enter into so-called barter agreements which are in many respects similar to the above. According to these barter agreements one country undertakes to supply the other with certain quantities of a specified commodity or commodities. For example, in December 1949 India and Argentina entered into an agreement according to which Argentina undertook to deliver 390,000 metric tons of wheat to India by a certain date in exchange for 50,000 metric tons of jute manufactures. Similarly, Mexico in 1950 entered into a $12 million barter agreement with Japan under which Mexico agreed to send Japan certain amounts of sugar in exchange for rails and railroad equipment. The agreement, as applies to Mexico, was to be carried out by two private Mexican corporations. Barter agreements do not always refer to prices or values, but may describe the trade entirely in terms of physical

quantities, although customarily prices and exchange rates are specified.

Numerous other examples of trade arranged by government agreements might be mentioned. A network of these agreements exists under which a substantial portion of the world's trade is regularly carried on. The widespread use of these agreements is due, it is to be noted, largely to a continuance of payments problems and to failure of governments for one reason or another to solve them. The European Payments Union, developed because of these payments problems, provides for a periodic clearing of balances and for the financing of a portion of the net balances which remain after the clearing. It is discussed in Chapter 24.

Bilateralism.—Trade and payments agreements, in spite of their serious drawbacks, have perhaps increased the amount of trade that has moved. During the depression of the 1930's they made possible a certain amount of trade which would otherwise not have taken place, and which was profitable to both parties. They permitted surplus goods to be exported, and shortages of certain materials to be relieved. They also facilitated the liquidation of frozen claims. In the postwar period of exchange disorders, payments problems, and inconvertible currencies, these bilateral agreements similarly facilitated trade.

In addition to overcoming payments problems, these agreements, it is sometimes said, may lead to additional trade through arranging for its financing, since the agreements establish mutual lines of credit for the specified trade. They also can provide assurances to a country regarding the availability of certain desired imports during the period of the agreement.

Bilateral trade and payments agreements, however, are essentially a substitute for more efficient and economic multilateral trade unhampered by currency inconvertibility and related restrictions. Except for their limited advantages in periods of disturbance they are usually harmful to world trade and to the countries participating in them. The bilateral agreements do not permit buyers and sellers latitude to seek the best market in whatever country that may be. Trade and payments agree-

ments, as statistics show, tend to alter the direction and nature of trade from what these would be on a free multilateral basis. They thus interfere with the advantages which result from the free market system, as discussed in other chapters. They are, however, in the case of most countries, an integral part of the present day institutional framework of government intervention in economic life.

The essentially uneconomic nature of bilateralism, in spite of certain limited advantages, has been stated by Professor Howard Ellis as follows:

> All direct controls permit the substitution of the judgment of authority for the collective (and sometimes harsh) judgments of the market place. Import controls permit the imposition of judgments as to what people should get or would want. Bilateral clearing arrangements may (but do not necessarily) produce balance in a country's international accounts.
>
> Because of the restriction upon both exporters' and importers' freedom of choice, bilateralism inevitably involves a smaller volume of profitable international trade. But bilaterally controlled trade probably can be made more *stable* than free multilateral trade, and the trading authority may prefer to purchase this stability at the cost of the standard of living. In a general situation of deficient gold and hard-currency reserves and of quite arbitrary exchange rates, bilateralism does "permit some trade to go on"; but the "some" is—for the reason given—less than would be possible under a functioning multilateral system.[1]

State Trading.—In addition to exercising supervision and control over foreign trade through regulatory devices or through trade and payments agreements, governments themselves engage directly in importing and exporting commodities. In completely socialized countries such as the U.S.S.R. and those of Eastern Europe foreign trade is no longer carried on by private traders but is conducted entirely by the government, usually through the instrumentality of trading monopolies owned and operated by the government. In most other countries governments engage in foreign trade operations only in special circumstances and rely on private traders for the bulk of transactions.

[1] Howard Ellis. *The Economics of Freedom.* Published for the Council on Foreign Relations by Harper & Bros., N. Y., 1950, p. 54.

The total amount of the world's trade that is carried on directly by governments is substantial, even if we exclude that of the socialized states. In the case of wheat, for example, the United Kingdom has a long-term contract with the Canadian Wheat Board, a Canadian Government agency, to purchase wheat which is an essential import into the United Kingdom. Similarly, Argentina, not a signatory to the Wheat Agreement, has long-term contracts with Italy, the Netherlands, Switzerland, Czechoslovakia, etc., to sell them wheat. The United States is the only major wheat exporting country that does not have a government trading monopoly in wheat. The United States Government, however, is now a monopoly buyer of all natural rubber imported into the United States, and is almost a monopoly producer of synthetic rubber produced within this country. Bulk purchasing agreements, as they are called, are utilized by governments to acquire agricultural and numerous other types of commodities, especially raw materials important in the country's economy.

The nationalization of certain industries by governments, which has taken place in a number of cases, means that the products of these industries must be marketed by the government, which is usually done through a government agency for this special purpose. In countries other than the completely socialized states, the industries to which nationalization has been applied generally include only industries which serve primarily the domestic market. Their operations therefore do not concern foreign countries to any great extent. Public utilities, including transportation agencies, are frequently operated by government, but these do not ordinarily compete with foreign companies, except in the field of aviation and shipping. When, however, the products of state enterprises are sold abroad, certain problems arise regarding costs, possible discrimination, and the observance of generally accepted commercial standards. These are discussed below.

In the U.S.S.R. and the countries of Eastern Europe the governments have nationalized practically all industry, banking, and foreign trade. Trade there is carried on by state-owned trading monopolies, which are usually stock companies estab-

lished to conduct the foreign trade in particular commodities. Individual industries in these countries do not negotiate with foreign buyers or with foreign suppliers, but operate through these trading monopolies. The monopoly obtains offers from foreign purchasers and procures needed materials.

The officers of these trading monopolies are appointed by the government, usually the Ministry of Trade, and are under the constant supervision of the government. The supervising ministry establishes export or import targets and may determine the prices and other details of the transactions. Any profits that are earned are turned over to the government. In some cases, as in Rumania, the foreign trade monopolies not only conduct foreign trade but also produce the articles exported. In Czechoslovakia and most other countries which have state trading monopolies, production and foreign trade are carried on by separate agencies. The pattern, however, varies from country to country.

The governments in these countries commonly negotiate trade agreements with other governments and then inform the foreign trade monopolies of their responsibilities under the agreement. In many cases, however, as for example in the Soviet Union, the officers of the government corporations may negotiate and conclude the agreement on behalf of the government. The quantities of commodities to be delivered are specified in the agreement, but the prices and delivery dates are frequently to be negotiated by the monopoly with the foreign buyer. The foreign buyer may be a private trader or another state trading monopoly. The countries in which state trading monopolies exist desire, for political reasons, to expand trade with each other. Nevertheless, these trading monopolies are generally glad to do business anywhere and with private traders as well as with government agencies. They need certain commodities from Western countries, and desire to earn through exports the currencies necessary to purchase such needed commodities.

A small and relatively unimportant amount of foreign trade remains in private hands in the countries which have nationalized their foreign trade. In these special cases the trade has

not been disturbed since it was believed that the trade might be lost by nationalization. A few agents of foreign companies are also allowed to transact business in these countries, but this type of activity is narrowly restricted.

The countries which have nationalized their foreign trade generally have five-year or similar economic plans. A principal aim of these plans is to bring about greater industrial output, which for its realization requires certain kinds and quantities of imports. The operations of the state trading monopolies are therefore geared to over-all economic planning, and particularly to increased industrialization of the country. The import targets thus consist of carefully selected lists of commodities which will contribute to realization of the main plan, which is believed to be desirable for the country. In order to be able to import the selected list of commodities, exports must not only be at an adequate level but must, as long as currencies are inconvertible, earn the appropriate kinds of currencies.

Economic Aspects of State Trading.—The extent to which government planned and conducted foreign trade effectively meets the needs of the community and contributes to economic development and higher living standards has been subject to much debate. The fundamental economic aspects of state trading are essentially the same as those that apply to the nationalization or socialization of production generally, although state trading has certain peculiarities of its own. The nationalization of foreign trade has usually been preceded by nationalization of banking and of most industry, and is usually an integral part of a program for the socialization of the economy. The Soviet foreign trade monopoly, however, established in 1918, antedated most nationalized control in industry, and also preceded by about ten years the process of collectivization of agriculture.

The profit motive and competition as driving forces to achieve greater efficiency and a larger production (and consumption) of goods of the kinds and in the amounts which the public decides it wants (as indicated by demand and prices), are replaced under socialization by the decisions of government officials and the various measures which they employ to imple-

ment these decisions. Socialization of production and of the marketing of the product thus abandon the forces of free enterprise, and rely on government administrators to obtain an increasing volume of production to distribute it, to inaugurate the improvements and adaptations to changing tastes and conditions which are constantly necessary, and to determine the kinds of commodities and services which it believes the public wants or should have. The cost and price mechanism, which in a free market registers demand and supply forces and induces the needed adjustments automatically, is replaced by an administered system wherein consumer requirements are calculated by government officials, and the means of meeting them determined and executed by government officials.

A complete analysis of the economic aspects of this subject is inappropriate here, but it may be noted that while the system of production and distribution by competitive free enterprise has its weaknesses and requires regulation, and in certain of its areas may advantageously be replaced by government enterprise as all governments have discovered, government production and distribution of the product by negotiation rather than by competitive buying and selling, do not make use of the pressure constantly and effectively applied by competition to improve methods, expand output, and eliminate waste and inefficiency. Socialized industry and trading also lack a reliable guide for the adjustment of production and trade to the kinds and amounts of goods desired by the persons for whom the goods are produced. Private enterprise and the free market mechanism may not always bring about the production and consumption primarily of those goods which are in the social sense the most desirable. Government intervention of various forms is frequently necessary, and under the free enterprise system, frequently takes place to enforce certain standards in the interest of the public, its health and welfare. For the great bulk of commodities and services, however, the evidence seems to indicate that the free enterprise system provides the public with larger amounts and better quality of what it wants than in the case of government administration of the details of the economic system.

Private enterprise constantly weeds out the high-cost inefficient producers and distributors, and favors the low-cost, efficient ones who meet the public's wishes most effectively. It utilizes individual ingenuity and initiative and provides for the allocation of labor and resources as determined by comparative advantages and consumers' desires. The abuses which tend to accompany unregulated private production and trade can, according to most American thinking, adequately be dealt with by government without discarding the advantages of free enterprise. These advantages have included, as exemplified in the United States and other countries, a large and spectacularly expanding volume of production on a basis of lower and lower costs. Serious fluctuations in output and employment, sometimes charged against the American system, are not a necessary part of the free enterprise system and are rapidly being solved.

While the world has had less experience over a period of years with socialized production and distribution, the record of socialism thus far is not impressive. It has accomplished considerable in the U.S.S.R., although it has been accompanied there by suppression of freedom and a disregard of the individual's desires, not only as regards consumption, but as to the nature and location of his work and many other matters where independent choices are not permitted. Socialism is perhaps at its least handicap in the case of countries in which the problem is to a large extent that of utilizing the experience of others, and where pioneering activities or those requiring imagination and experimentation are less important. High potential rewards may be needed to stimuate the latter. Russia was in a position to utilize the technology of other countries. The line between the two systems is, of course, not clear cut and a large number of countries have so-called mixed systems.[2]

The conduct of international trade by state trading agencies raises a number of problems with respect to trade between state trading countries and free enterprise countries. State trading, involving state determination of prices and terms of sale, opens the door to discrimination and to the manipulation of prices,

[2] See Chapter 34 for a further discussion of the free enterprise system and mixed or administered economies.

quality, availability, etc. State determination of these matters may not be in harmony with commercial standards and with what is generally considered fair competition. The standards of the free enterprise competitive system do not necessarily guide a government in administering its system of trade and production. Government agencies may dump large quantities of a certain commodity on the foreign market regardless of costs or at costs which exclude items of expense which private enterprise must entail. Such agencies may desire the currency of a particular country, or for other reasons may largely ignore commercial and profit considerations. Political motives may be mixed with economic considerations and may lead to a channeling of transactions in certain directions, or the creation of artificial scarcities.

Attempts have been made to deal with this problem, but a satisfactory solution is difficult if governments have different objectives and economic philosophies. The Charter of the proposed International Trade Organization endeavored to establish certain standards for state trading, and to deal with the problem by providing that a state enterprise "shall, in its purchases and sales involving either imports or exports, act in a manner consistent with the general principles of non-discriminatory treatment prescribed in this Charter for governmental measures affecting imports or exports by private traders." [3] Government enterprises, it provided, shall make "purchases or sales solely in accordance with commercial considerations, including price, quality, availability, marketability, transportation and other conditions of purchase or sale, and shall afford the enterprises of the other member countries adequate opportunity, in accordance with customary business practice, to compete for participation in such purchases or sales." The Charter was not accepted by the United States Congress. The United States Government in its treaties of Friendship, Commerce and Navigation has a provision along the same general lines. It will be noted that the above provisions are flexible and leave considerable room for interpretation, a neces-

[3] Article 29.

sary weakness. It is not possible to deal with a matter of this kind in rigid terms.

Regardless of formal commitments endeavoring to establish standards of conduct for state trading agencies, much depends on the policies of the governments and the extent of their desire to cooperate economically with other countries on a basis which recognizes the international responsibilities of all countries. It is not impossible for private trade and state trade to exist side by side on an amicable and mutually advantageous basis, and for private traders and state agencies to carry on operations with a minimum of difficulties if both the trading countries so wish and are not excessively nationalistic in their approach to economic questions. State trading or state participation in trading has become extensive and well established, so that the two systems must learn to live together, at least for the present.

Chapter 22

EXCHANGE RESTRICTIONS—MULTIPLE RATES

Nature of Exchange Restrictions.—The terms "exchange restrictions" and "exchange control" refer to government measures which restrict the purchase or sale of foreign exchange. Under a system of exchange control supplies of foreign exchange may not be freely expended by their owners for imports or other purposes, but are subject to various limitations. In order to administer a system of exchange control, or exchange restrictions, a government usually requires that exchange be turned over in whole or in part to government agencies for sale by them, or for sale by banks, but only for purposes and according to regulations prescribed by the government.

Restrictions on the purchase and sale of exchange have in recent years been imposed during periods of exchange shortage when exchange holdings have been inadequate to meet fully the market demand at the established rate of exchange. The original and primary objectives of exchange control are to prevent depreciation of the rate of exchange because of the excess of demand over supply at the established rate, and to arrange for priorities in the allocation of the available exchange, giving preference to purchases for the importation of essential goods and services. Other purposes of exchange control, however, have come to include the protection of local industry, and in some cases the furthering of political objectives. Protection has come to be a major purpose of exchange control and is a deterrent to a removal or relaxation of restrictions.

When the price of a commodity or foreign currency is held below the market level, rationing of the available supply becomes necessary. If the supply of foreign exchange is ample to meet all prospective demands at the fixed rate, there is no

need for exchange control, except as a government may nevertheless wish to select the types or amounts of goods imported, or otherwise to determine the purposes for which exchange can be bought. Under conditions of exchange shortage the absence of exchange control would mean that a lower exchange rate would be needed in order to equilibrate demand and supply. Such a rate might temporarily be very low and, in fact, disruptive of trade and production, especially in cases where the supply of exports and the demand for imports are not responsive to changes in the rate (inelastic demand and supply), and where adjustments in production are slow, as discussed in Chapter 6. Exchange control can promote exchange rate stability while necessary measures to bring about economic adjustments are being taken. On the other hand, if the disequilibrium is not temporary, and if a lower exchange rate is needed to bring a fundamental balance in international accounts, exchange control may have the effect of deterring or delaying the needed adjustments.

Exchange control permits discrimination against certain imports, and can thus be used as a protective device against foreign competition, or as a means of discriminating against certain countries. These subjects are discussed below.

Origins of Exchange Restrictions.—Government efforts to avoid depreciation and to maintain a stable exchange rate have a long history. It was not until the 1930's, however, that direct control over the purchase and sale of exchange, in the interests primarily of providing for essential needs, was undertaken by governments, except in isolated instances such as during and after the first World War principally to prevent capital exports. Before the first World War, central banks commonly engaged in operations designed to affect indirectly the demand and supply of foreign exchange, and thereby to promote exchange stability at the fixed rate. Thus increases in the central bank's discount rate were often for the purpose of checking credit expansion, the loss of gold, and the flow of funds out of the country, so as to reduce pressure on the exchange rate. Maintenance of exchange rate stability was, in the case of most

countries, a major objective of financial policy. Such stability was usually accomplished through the mechanism of the gold standard, and central bank actions were accordingly designed in large part to assure the maintenance of free gold payments at the fixed rate.

During the 1920's exchange stability, when finally achieved after the war, was maintained by free central bank sales of exchange at the fixed rates, supported by gold reserves and balances held largely in New York and London. Sales of exchange freely by government institutions took the place to a large extent of free currency redemption in gold. Governments or their central banks also on occasion undertook direct stabilization operations by entering the market either as a buyer or seller of exchange as the situation demanded. During this period no license was required to purchase foreign exchange, so that funds were in general freely transferable from one country to another at the prevailing rates. International accounts were in approximate equilibrium at these rates.

The depression which became severe in the early 1930's changed this situation drastically. Output and employment declined greatly throughout practically the entire world with disturbing effects upon international trade. The extent and timing of the decline varied from industry to industry and from country to country, with the result that an unbalanced condition was created in international accounts. This unbalanced condition in payments and receipts led to shortages of exchange on the part of many countries. Furthermore, the large amount of foreign lending which had taken place during the previous decade by the United States and the United Kingdom, especially to European and Latin-American countries, came almost to an end during the early thirties. This drying up of a source of supply of dollars and pounds took place at a time when trade was already reduced both in volume and in value, due in part to lower prices, and was in an unbalanced condition. Shortages in foreign exchange holdings became increasingly the source of difficulty to countries endeavoring to maintain stable exchange rates, and at the same time meet their foreign obligations and provide for a flow of essential imports.

A further disturbing influence on the exchanges was the erratic movement of capital. Capital fled from one country to another seeking a haven from political and economic insecurity, from anticipated exchange depreciation, or from restrictions which would prevent the transfer of funds out of the country.

London had long been a financial center where transactions throughout all parts of the world were financed and cleared. Leading banks which engaged in international financial transactions ordinarily maintained sterling balances in London in order to carry on their business and make settlements. The pound sterling was freely convertible into gold or dollars without restriction, and therefore was widely used as a currency for the conduct of international trade.

Following heavy withdrawals of funds from London, however, Great Britain in September, 1931, suspended gold payments, with the result that the pound depreciated rapidly. Countries whose central banks had maintained balances in London as part of their currency reserves and had used these reserves to maintain their exchange rates at par with gold and the dollar, suffered losses in the value of these reserves as the pound declined in the exchange markets. Many of these countries were therefore unable to maintain their existing exchange rates. Widespread exchange depreciation and sharp fluctuations followed. The international clearing system which centered in London was disrupted by these events. The existing imbalance in international accounts was further aggravated.

The scarcity of dollars and other gold convertible currencies was particularly acute in debtor countries which had interest and principal payments to make on obligations owed abroad and payable in foreign currency, principally in dollars. The rise in exchange rates on gold countries following the British departure from gold made the servicing of such obligations increasingly burdensome, in addition to the domestic burden of raising revenue during a period of depression and stagnant trade. Defaults were therefore extensive. Under these conditions the maintenance of a flow of necessary imports became a serious problem for several countries.

As a result of this situation, exchange control came as a

logical development. It was basically an attempt to see that exchange was available for essential needs and at the fixed rates. The limited supply of foreign exchange was accordingly allocated among competing buyers on the basis of essentiality as determined by the government.

Although exchange control was originally a stop-gap means of meeting an emergency situation it opened the way for regulation of the country's entire foreign trade and other transactions. Through exchange allocations it was possible to encourage certain transactions and to discourage or prohibit others, with important consequences. The original purpose of exchange control had been merely to see that exchange was available to pay for the importation of essential goods and services and to protect exchange rates from depreciation. Soon, however, exchange control was also used to protect home markets against imports, to discriminate in favor of or against certain countries, and for other nationalistic ends. As practiced by some countries, notably Germany, it became an instrument of economic warfare. In conjunction with clearing agreements, it was used, again particularly by Germany, to promote economic nationalism and preparation for war, and to undermine the multilateral trading system of other countries.

When war broke out in 1939 and when trade was accordingly disrupted, exchange control was continued and extended as a necessary wartime regulatory device. Practically all countries during the war enforced rigid systems of exchange control as a means of assuring the effective utilization of their exchange holdings as well as of maintaining fixed exchange rates.

The end of the war in 1945 found production and trade seriously dislocated, and widespread imbalance in international payments and receipts. Transportation, public utilities, and productive facilities generally had been destroyed, disorganized, or converted to war purposes. The practical elimination of Germany, Japan, and other countries as markets and sources of supply contributed to the disequilibrium. Under such conditions exchange control was essential to prevent severe exchange depreciation, speculation, and additional hardship for large masses of people dependent upon imports.

Continuance of exchange control into the postwar period was therefore desirable until productive systems could be restored and international trade could again flow on a more normal basis. Exchange control, however, once instituted, has a tendency to perpetuate itself and to make difficult the restoration of a relatively free multilateral trading system. Exchange restrictions, in fact, became in many countries the principal means of dealing with balance of payments deficits, and tended to be regarded as regular and continuing arrangements. They delayed necessary exchange rate adjustments and the taking of internal measures needed to bring equilibrium into international accounts. Exchange restrictions also concealed from the public the extent of the prevailing maladjustment, and therefore facilitated postponement of remedial measures.

Exchange Control Procedures.—Under a system of exchange restrictions the purchase and sale of exchange are subjected to official regulation as noted. To administer an exchange control system imports and other transactions involving foreign payments are classified into various categories on the basis of their essentiality. The main categories are usually subdivided according to particular commodities such as certain raw materials, machinery, food, automobiles, television sets, etc. Each of these groups is treated separately in the allocation of foreign exchange. Certain luxury imports may be allowed very little exchange or perhaps none at all, whereas food imports, for example, may be granted exchange relatively freely. Licenses are issued to applicants either on a discretionary basis on the part of the government, according to the estimated merits of the individual transaction, or on the basis of established criteria such as the previous imports of the applicant, his capital, or some other standard. The latter procedure involves in effect the fixing of quotas for individual importers, and while it is definite and obviates some of the difficulties of discretionary allocation, it lacks flexibility and has difficulties of its own.[1]

[1] A code of standard practices for the administration of exchange controls was adopted by the parties to GATT in 1951. See page 363.

Licenses are sometimes issued on the basis of first come first served, up to the limit allowed for the particular category. This method also eliminates some of the difficulties of discretionary allocation, but does not assure an equitable distribution of the available exchange. Another method is that of the waiting list, which is a form of the quota system and involves postponement of an application rather than rejection. It similarly does not assure an equitable distribution of exchange. Tie-in import arrangements require that an importer who is allocated exchange purchase specified amounts of similar domestic products. Such arrangements it will be noted provide protection for domestic producers.

In order that a system of exchange restrictions may operate effectively it is necessary not only that purchases of exchange be regulated, but that receipts of exchange by exporters and others either be directed into a central pool or be disposed of according to established procedures. Recipients of exchange are thus ordinarily required to sell their exchange to a government agency in return for domestic currency. The selling rate which they receive is fixed by the government. The recipient of exchange is thus not allowed to sell his exchange to the highest bidder—at least not legally. In order to enforce supervision over receipts of exchange and to minimize evasion of regulations, governments may require exporters to obtain export licenses. The government in this manner obtains information regarding transactions, although the information may not always reveal the full value of the export. The government, in granting export licenses may require that the foreign buyer make payment in a specified foreign currency. An exporter thus must receive dollars or some other specified foreign currency from his buyer rather than an undesired currency, perhaps his own local currency which the foreign buyer might have acquired by various means.

Frequently the recipient of exchange is allowed to sell a portion of his receipts on the free market, where importers of luxuries or semiluxuries are permitted to purchase exchange but at rates above those officially determined for other transactions. Receipts of exchange from certain sources, such as ex-

change offered by tourists, may be allowed to be sold without restriction and at whatever rate is obtainable. The rate in such cases is usually high and unfavorable to the buyers of exchange but favorable for the sellers. This so-called free market is not a broad representative market since the kinds of transactions which are allowed access to this market are limited and may be altered by the government. The partially free market rate is thus of dubious significance with respect to indicating what a free rate for all transactions would be. Invisible transactions are often carried out legally in the partially free market.

In countries which do not have a legal free market, exporters are sometimes allowed to retain a portion of the proceeds of their exports to the dollar area, and to use the amount retained for such purposes as to import goods for which exchange would otherwise not be available, or to make payments in the dollar area. The proceeds retained, however, are not to be sold for local currency. They are usually used to import goods (for example, nylon stockings) on behalf of a merchant who buys the goods at an attractive price. The retention quota, as it is known, usually varies from 10 to 20 per cent of the receipts from an export.

An auction market is a form of free market and is characterized by the fact that the government or its monetary authority supplies part of or all the exchange that is sold. The exchange is sold to the highest bidder and the monetary authority as seller receives the profits from the high rates rather than the exporters as in the case of other free markets.

Exchange control systems sometimes provide for what are known as private compensations, wherein certain categories of exporters or other recipients of exchange are allowed to sell all or part of their exchange receipts to certain categories of importers or other purchasers of exchange, on a free basis. The thought underlying compensation arrangements is that if an exporter can export a commodity which would otherwise not be exported, the proceeds may be used for the import of commodities which would otherwise not be allocated exchange. A single exchange rate tends to prevail in such a market. In some instances receipts from a particular type of export may

be sold only to purchasers using them for a particular type of import. This pairing of particular exports with particular imports may result in several rates of exchange.

One of the problems constantly confronting exchange control authorities is that of the black market wherein exchange is bought and sold in disregard of official regulations. Black markets vary in extent from country to country, and in some cases operate more or less in open defiance of regulations. Accurate figures on the volume of black market transactions are not available but in some countries it is estimated that two-thirds or more of the exchange sold is disposed of on the black market. Such gross violation is doubtless not representative of the situation prevailing in all countries, although no country with exchange restrictions is free from black market operations. When the official rate is far below the free rate, so that profit opportunities are great, the temptation for violations is most extensive. Illicit operations and the accompanying corruption, which in varying degrees surround practically all exchange control systems, are one of the serious evils of such systems.

Exporters frequently evade exchange regulations by retaining and not reporting a portion of the proceeds of their sales. Double invoices, one for official inspection and one which is not shown, facilitate retention of a part of the foreign exchange received from transactions. The foreign purchaser of exports may connive in the arrangement and pay part of the proceeds into a special bank account which the exporter maintains abroad unknown to the authorities of his country. The proceeds withheld may then be sold privately for local currency or may be retained abroad by the owner. Similarly, importers may evade regulations by overvaluing the goods imported and thereby obtaining more foreign currency than needed. The export of capital may thus take place despite restrictions designed to prevent it. Travelers in countries with exchange restrictions are commonly accosted and offered an attractive black market rate for their foreign exchange. American tourists are well familiar with this procedure. When many countries had seriously unrealistic exchange rates during the years following the second World War, most American tourists in a number of these

countries disposed of their dollars to black market operators. The practice was so widespread that it was scarcely considered improper.

Multiple Exchange Rates.—A system of two or more rates of exchange for a particular foreign currency is known as a multiple rate system. In a free market it is, of course, impossible to have more than one or essentially one rate for the same currency, so that multiple rates exist only when the purchase and sale of exchange are controlled. A buying rate and a selling rate that are not far apart, e.g., not more than one per cent apart,[2] are not considered multiple rates since a small spread to provide for costs, including a reasonable profit, is customary in all exchange markets. Thus in the absence of restrictions banks buy exchange from exporters at one price and sell the exchange to importers at a slightly higher price, the amount of the differential or spread being limited by competition.

Under a system of exchange control, purchases and sales of exchange must be consummated at the official rate. Purchases or sales at any other rate are illegal. Exchange control systems, however, frequently provide for several buying and several selling rates of exchange for the same foreign currency, the particular rate applicable to a transaction depending upon the nature of the transaction. Thus imports which are considered essential may be allocated exchange at a low and favorable rate, whereas luxuries must pay a higher rate of exchange. Similarly, it may be required that receipts from exports be sold to the authorities at rates which vary according to the kind of commodity exported, a favorable rate being given to commodities which the government wishes to encourage.

Multiple rates, which often accompany exchange restrictions, are themselves a form of exchange restriction. They cannot, as noted, exist outside of a system of restrictions on the purchase and sale of exchange. In the absence of such restrictions all exchange transactions tend to take place at a single or unitary rate as determined by competitive buying and selling. Multiple

[2] The International Monetary Fund permits a spread of one per cent. Cf. I.M.F. Articles of Agreement, Article IV, section 3.

rate systems are more common among Latin-American than among European countries. Their use has recently been increasing in Southeast Asia.

The purposes and consequences of multiple rates are to a large extent the same as those of direct or quantitative exchange restrictions noted above. Exchange restrictions of the quantitative type, which is the type usually referred to where the term is used, limit the quantity of exchange allowed for a particular kind of transaction, and thereby limit the amount of the particular commodity that is imported. In a multiple rate system an unfavorable rate for a transaction limits the amount of the commodity that is imported by increasing the cost of the transaction. Not infrequently the restriction is a composite one in that it combines the two methods; namely, the quantity of exchange allocated to a particular type of transaction is limited, and this exchange must be bought at a high rate.[3]

Multiple rates have several objectives. The purpose is usually to limit imports on a selective basis because of an exchange shortage. Like quantitative exchange restrictions and other methods of limiting imports they are a means of dealing with a balance of payments deficit and of providing exchange for essential imports. A government may thus facilitate the importation of food by granting exchange at a low rate, but may discourage the importation, for example, of expensive automobiles by granting exchange for such imports only at a high rate. Similarly, the receipts from certain kinds of exports may be allowed an especially favorable rate in order to expand such exports, whereas the receipts from other exports must be turned over to the authorities at a rate or rates which are less favorable. Thus Venezuela provides high and favorable rates to the exporters of coffee and cocoa, but a lower and less favorable rate for the proceeds from petroleum exports. Venezuela desires to aid the production of coffee and cocoa in the interests of diversification. The low rate for petroleum is in effect a form of export tax on petroleum.

[3] The International Monetary Fund classifies exchange restrictions into three types, quantitative, cost, and composite. Cf. First Annual Report on Exchange Restrictions, International Monetary Fund, Mar. 1, 1950.

The principal arguments advanced in behalf of multiple rates are as follows:

1. They are useful as a temporary device to limit imports, especially on a selective basis, in periods of balance of payments deficits until fundamental adjustments can be made.
2. They permit the stimulation of desired exports, as well as the discouragement of undesired imports, thereby facilitating the planning of economic development.
3. They amount to partial devaluation, i.e., for the transactions assigned higher rates, and constitute a transitional measure where full and immediate devaluation is politically or economically difficult.
4. They may be designed so as to prevent windfall profits from devaluation from going to exporters in general by denying exporters the benefit of higher rates. The government receives this profit by purchasing exchange from exporters at the regular rate and selling part of it to importers of nonessential goods at a higher rate. Governments frequently find multiple rates a lucrative source of revenue.

The disadvantages of multiple rates, however, are impressive. In the first place, whatever advantages accompany such a system can all be accomplished by other means which do not involve the drawbacks of multiple rates. These other means include taxation, subsidies, devaluation, and fiscal policies. Excise taxes, for example, which apply to domestic goods as well as to foreign goods, can be used to limit the consumption of luxuries without affording protection for a domestic luxury industry, which is the result of a penalty import rate on luxuries. Multiple rates, like quantitative exchange restrictions, are frequently used to avoid the taking of economic measures which are necessary but unpleasant and politically unpopular, such as devaluation or the checking of inflation. They therefore delay fundamental adjustments and permit the perpetuation of unhealthy economic and financial conditions. By reducing imports they conceal the basic lack of balance in the country's international accounts, and tend to reduce rather than expand trade.

By denying profits to exporters through forcing them to sell their exchange at the official rate, a major stimulus to the expansion of exports is removed. Commonly in periods of exchange stringency the country's internal prices and costs have already risen, and exporters, particularly marginal exporters, have difficulty in competing in the world market. A higher exchange rate, and therefore larger receipts in local currency, are usually the appropriate means under the free enterprise system, of relieving the difficulty. Under the free enterprise system greater profits, or perhaps the restoration of profits which have shrunk, constitute a main and powerful stimulus to an expansion of production and of exports. If, on the other hand, the exchange stringency is not accompanied by inflation, but is due, for example, to a bad export crop or to a temporary disturbance, some method of import control other than devaluation may be indicated. A multiple rate might then temporarily be useful. Similarly, if an expansion of exports does not appear a probable result of devaluation, a multiple rate may prevent windfall profits from going to exporters and for the time being serve a useful purpose. The evidence, however, that such cases where multiple rates can legitimately be employed often exist, is not convincing.

Multiple rates may be used for discriminatory purposes, not only against certain commodities but against imports from particular countries. While their discriminatory nature is considered one of their main utilities, as noted above, i.e., the importation of undesired commodities or the sale of a scarce foreign currency can be limited, it is also the source of possible abuse. Unfavorable rates may be used to limit foreign competition and protect uneconomic domestic producers, or to exert pressure on certain countries and thereby seek political advantages.

The main disadvantage of multiple rates has to do with the fact that they are inconsistent with a reasonably free multilateral trading system. They interfere with the general elimination of exchange restrictions, and with the expansion, under pressure from the forces of free enterprise and competition, of employment, production, and trade, and with the realization of higher

standards of living based on consumers' desires freely expressed. Unitary exchange rates and a world trading system relatively free from burdensome restrictions are major objectives of United States foreign economic policy as noted in Chapter 34. They are also objectives of the International Monetary Fund as embodied in its Articles of Agreement.

Broken Cross Rates.—When currencies are inconvertible and exchange rates are pegged by control devices, there frequently arise what are known as broken cross rates. The cross rate for a currency refers to the rate for that currency via a third currency. For example, in 1949 when the rate in New York for sterling was \$4.03 and the rate for Italian lire was 575 lire per dollar, the rate in Italy for sterling should on this basis have been about 4.03 times 575, or 2317 lire for one pound. The rate in Italy for sterling, however, was for a time about 1850 lire per pound, so that in the United States the cross rate for sterling via Italy was about \$3.20, involving a discount on sterling of about 20 per cent.

Under free market conditions persons in New York desiring sterling would, under the above conditions, have found that the cheapest way to obtain it was to buy Italian lire and sell the lire for sterling. Furthermore, persons in New York who thus bought sterling via Italy at a 20 per cent discount could with the sterling then have bought in London dollars in New York at the \$4.03 rate, and have made a quick profit with practically no risk. If such operations had been freely permitted they would have prevented the continuance of the broken cross rate. Under a free market, arbitrage operations of this kind would tend to lower the price of sterling in New York and to raise it in Italy until the three currencies were approximately in line with each other. When currencies can be bought and sold freely cross rates tend to remain in line. In the above case of a broken cross rate, however, sterling bought in Italy was not freely transferable and could not be legally used to pay for exports from the United Kingdom to the United States.

When a currency is inconvertible, that is when the purchase and sale of foreign currencies are restricted and the transfer-

ability of the currency is limited, the tendency is for broken cross rates to exist for that currency in countries where the restricted currency is bought and sold in a free or partially free market. Broken cross rates, it will be noted, are due to the compartmentalization of the market. They may also exist where exchange rates are pegged officially at levels which involve a disparity in cross rates. Management of rates to avoid broken cross rates must ordinarily be done by the country which has a surplus in its trade, Italy in the above case, inasmuch as the country whose currency is at a discount can do little about it, unless it wishes to make its currency partially convertible. For example, in the above case the United Kingdom could have purchased pounds in Italy (with dollars or with other currencies), and thus have forced their price up to the indicated rate. Such an operation would have been the equivalent of the United Kingdom settling its deficit with Italy by the payment of dollars or other currencies equivalent to the dollar at the $4.03 rate, i.e., giving an Italian exporter to the United Kingdom convertible sterling.

A broken cross rate based on inconvertibility and restricted transferability may lead to arbitrage of commodities. Under the above conditions an Italian might advantageously buy commodities in the sterling area, paying for them with cheap sterling ($3.20), and sell the commodities in the United States, where sterling was not depreciated. The dollars which he received from the transaction would thus be channeled to Italy instead of the United Kingdom. Similarly, it was advantageous for an Italian to buy United States goods for importation into Italy through the sterling area, insofar as possible, paying for them sterling costing in lire the equivalent of $3.20 instead of buying dollars at a price in lire equal to $4.03.

Broken cross rates have existed in a number of instances and have usually involved a depreciation of sterling, such as in the case of France, Italy, Thailand, Hong Kong, Lebanon, and Peru. Commodity transactions like those described above have taken place when broken cross rates have offered sufficient inducement. The International Monetary Fund seeks the avoidance of disorderly cross rates.

Economic Aspects of Exchange Restrictions.—The effects of exchange restrictions, including multiple rates, are in general similar to those of tariffs, quantitative restrictions on imports, and other devices which limit international trade. Differences in the effects of these devices, however, exist, especially in the effects upon the incomes of particular groups of persons, and also upon the income of the government itself. The effects of tariffs and other trade barriers were discussed in Chapter 18, and to avoid repetition the similar effects of exchange restrictions will be referred to only briefly here.

Exchange restrictions by reducing imports tend to bring a balance into international accounts in periods of deficit, which is supposedly their main function. A deficit, even though large, can be eliminated by the severe application of restrictions on the amount of exchange made available for imports, or by multiple rates which increase the cost of imports. A balance in international accounts can thus be forced by the imposition of exchange restrictions. This balance, however, will almost inevitably be at a lower level of total trade than would otherwise exist.

In the absence of restrictions which ration the supply of scarce exchange, a rate of exchange which depreciates the currency would prevail. Exports would ordinarily be stimulated by the higher rate, the amount of expansion depending in part upon their elasticity. The period of time required for such expansion varies, and in some instances little expansion may take place in the short run. A system of exchange control, however, does not of itself cause exports to expand to help relieve the deficit. Expansion may be sought by other means such as appeals to producers, allocations of scarce supplies, government subsidies, or perhaps by direct government trading activities.

Exchange restrictions remove a deficit by restricting imports rather than by expanding exports, and thus tend to reduce the volume of trade. They do not by themselves produce fundamental adjustments to bring a balanced condition in a country's international accounts except on a lower level of trade than would otherwise prevail. Furthermore, under exchange

restrictions the domestic consumption of goods that would otherwise be exported may increase, since export goods are relatively cheaper than import goods. Exports may thereby be reduced. Resources, moreover, may be attracted to the production of domestic goods and away from that of export goods. The domestic production of goods which could otherwise be imported more economically and cheaply than produced at home, may be encouraged. Inefficient domestic industry may be stimulated behind the protection of exchange restrictions. In general the tendency of exchange restrictions, it can be seen, is to narrow the volume of total international trade.

The importation of goods, such as food which may enjoy favorable treatment in the allocation of exchange and perhaps in rates, is encouraged by exchange restrictions as compared to the domestic production of such items. For example, a Latin-American country found that it was importing meat instead of producing it at home as formerly, since at the favorable rates the imported food was cheaper. This situation increased imports and the deficit.

Restrictions on imports almost invariably result in some redistribution of incomes. The prices of restricted goods tend to rise, accompanying the scarcity, unless price controls are in force and are fully effective which is seldom the case. Importers who succeed in importing the commodities, legally or illegally, tend to receive higher prices and profits than would otherwise be the case. These gains may be of a windfall nature. Exporters who are permitted to sell in free or partially free markets (perhaps at rates higher than would prevail in a completely free market) may also receive additional profits. Black market operators may carry on a thriving and lucrative business. Governments, moreover, often receive sizable revenues from import duties or from the sale of exchange, particularly when a wide spread exists between buying and selling rates. In view of their effects upon incomes, restrictions on imports stimulate or discourage particular kinds of productive activity.

Restrictions on imports tend to alter the pattern of international trade, and consequently to alter that of production and consumption. Exchange restrictions by reducing imports of

certain commodities and raising their prices encourage domestic producers to expand the production of such commodities. The protection which is afforded to certain domestic industry was not one of the original purposes of exchange restrictions, but has often become an important factor in their retention. The degree of protection afforded by such restrictions depends largely upon the extent to which the domestic market was formerly (or would be) supplied from foreign sources, and upon the elasticity of domestic demand and domestic supply, together with the extent of shifting to substitute commodities. Little protection, for example, would ordinarily be afforded in the case of a commodity wherein foreign sources account for only a small portion of the supply, wherein the domestic demand is elastic so that a slight rise in price reduces the volume of sales, and wherein substitute commodities are readily accepted by consumers.

Exchange restrictions if long continued thus channel productive resources into enterprises that are stimulated by the scarcities which exchange restrictions create. They channel resources away from the most efficient uses and from uses determined by consumers' choices. Whatever use is made of exchange restrictions, therefore, should be of short duration, and for dealing with temporary emergency situations. The longer they are retained the more difficult may be their removal as trade and production become adjusted to them and dependent upon their existence.

Exchange restrictions are in some instances used primarily as a means of discrimination against foreign countries and to provide protection from foreign competition. Exchange restrictions, it will be noted, are inherently discriminatory. They discriminate against or in favor of particular commodities and particular countries. Their purpose is supposedly to protect the balance of payments or monetary reserves. Restrictions, however, imposed originally for balance of payments reasons may in fact be retained partly or largely for the purpose of limiting the importation of competitive goods, or as a bargaining device with foreign countries.

In behalf of exchange restrictions, it is to be noted that the national objectives of a country are often of an intangible nature, although at times confused and conflicting, and may not always conform to those based on the principle of comparative advantage. Efficient production and an economic allocation of resources may not be considered as important to some countries as certain other goals which are not measured by demand and supply curves.

Exchange restrictions, on the other hand, may under certain conditions serve a useful economic purpose by facilitating exchange stability while remedial measures are being undertaken to relieve a disequilibrium. As a means of meeting deficit situations wherein the shortage of exchange is of a temporary character, such as when due to a crop failure or to some other event which will eventually disappear, exchange restrictions may be useful. They may also be useful in controlling a flight of capital. Capital movements of substantial size may take place suddenly and be disruptive of exchange rates and economic conditions unless some means of control are employed.

A clear case of the usefulness of exchange restrictions was during the period immediately after the end of the second World War when trade and production in many countries were seriously dislocated. A free exchange market under such circumstances would have resulted in severe depreciation of many currencies, and a pattern of exchange rates which would have been unrepresentative of the demand and supply situation which would prevail when trade and production were restored. Rates would not only have been greatly depreciated but would have fluctuated erratically. Speculators would have reaped large profits. As a result of depreciation essential imports would have been expensive, and excessive stimulation would have been given to exports at a time when reconstruction needs should not be required to contend with competition from export industries. At a time when commodity scarcities were widespread and could not be relieved quickly a market equilibrium rate of exchange would have caused needless hardship, would have brought undue profits to certain individuals and would

have retarded reconstruction. Government control over rates and over buying and selling of exchange thus made possible more orderly conditions than would have otherwise prevailed.

In cases where the supply of export commodities has relatively little elasticity, an increase in the exchange rate, unless large, would not be of much help in expanding exports and increasing reserves. The possible loss in the value of exchange receipts from exports as a result of the lower rate might under these conditions not be completely offset by larger exports, even though the receipts in local currency were higher. Similarly, when the demand for imports is inelastic the higher cost of foreign goods which would result from exchange depreciation would not cut off many imports. Under such inelastic conditions it has been argued that exchange restrictions are preferable to a rate adjustment. In most circumstances the evidence of inelasticity, however, is not very convincing. The experience of countries that have devalued indicates that such inelastic conditions are more theoretical possibilities than real actualities. Their experience reveals that a rate adjustment does expand exports and increase exchange receipts as discussed in Chapter 40.

The effects of exchange restrictions upon the terms of trade are difficult to identify, and while, as discussed in earlier chapters, a rate change may affect the terms of trade, it does not appear that exchange rate manipulation to improve the terms of trade is likely to result in much, if any, net gain, particularly when all of the consequences of exchange restrictions are considered.

If selectivity of imports is desired so that imports may be different from those resulting from the price system, i.e., if the imports that are cut off by a higher exchange rate are not those which the country desires to discourage, or if certain exporters receive excessive profits because of the higher rate, these economic developments or social objectives can usually be achieved through such means as taxation, subsidies, and other devices with less harm than results from the use of exchange restrictions.

Exchange control, once instituted, has a tendency to continue after the original need has passed, especially since restrictions

tend to foster interests which would be harmed by their removal. Restrictions may delay the taking of measures which are needed to remedy the disequilibrium and to make possible the elimination of such restrictions. Devaluation, an alternative to exchange restrictions, is unpopular with the public and is associated with inflation, although it is more a result than a cause of inflation. Predictions that devaluations would lead to materially higher costs of living have not been borne out by experience. Certain individual imported foods and other items may be increased in cost, which fact may in some instances impose a problem of subsidy, but countries which have devalued have not experienced much increase in the general cost of living traceable to devaluation.

Devaluation is considered by the public to be a sign of weakness and of failure of the government to deal effectively with economic problems. It is also disturbing to business and tends to make imported goods more expensive. Governments therefore desire to avoid it. Exchange restrictions conceal the extent of the disequilibrium and thus make it possible to postpone devaluation as well as the taking of unpopular measures of internal stabilization. A number of countries found it difficult after the second World War as a practical matter to abandon exchange restrictions and to adjust their unrealistic exchange rates. Uncertain political conditions and communist threats added to the difficulties of government administrators in undertaking necessary financial measures.

One of the serious evils of exchange restrictions is the corruption and black market activity which commonly accompanies it, and which was discussed above. Because of the black market and widespread violations of exchange regulations, exchange control systems are often not as effective in accomplishing their purpose as may appear on the surface. In some cases they are in fact quite ineffective, but governments nevertheless find it difficult or are reluctant to undertake devaluation and the measures necessary to establish a reasonably free market.

In conclusion, according to the views of persons who believe in the advantages of a liberal free enterprise system, exchange restrictions, like other barriers to trade, interfere with the ex-

pansion of production and trade, and with the raising of living standards. They tend to support inefficiency and uneconomic situations, as noted, and are inconsistent with a nondiscriminatory multilateral trading system. Such a system, free from burdensome restrictions, permits the forces of competition and free enterprise to bring their full force toward the realization of the above objectives. The United States desires to see the elimination of exchange restrictions as noted in Chapter 34. The Articles of Agreement of the International Monetary Fund specifically declare against them, and the Fund seeks their elimination or relaxation.

Chapter 23

STERLING AND THE STERLING AREA

Sterling Prior to 1931.—The pound sterling, divided into 20 shillings or 240 pence (and thus not on the decimal system), has a long history as an internationally recognized and widely used currency unit. The pound was continuously redeemable in gold from 1821, following the long suspension of specie payments (1797-1821) during the Napoleonic War, until the outbreak of the first World War in 1914. During this period it was worth approximately $4.86 in United States money. In all parts of the world British pounds were known and accepted as the practical equivalent of gold.

Immediately after the outbreak of war in 1914 the pound was no longer redeemable in gold, although this suspension of gold payments was *de facto* and carried out administratively rather than by statute. Legally the pound continued redeemable but as a practical matter redemption was not possible. The export of gold was prohibited by proclamation in 1917. During the first World War the pound-dollar rate was pegged at $4.76, but in 1919 the pound was allowed to seek its own level and depreciated greatly. Finally, in 1925 gold payments were resumed at the former rate equivalent to $4.86 per pound, and the export of gold was again permitted. Redemption in gold, however, was allowed only in large amounts. After the pound became again redeemable in gold London re-established its long-standing central position, weakened by the war and inconvertibility, in the trade and finance of a large part of the world. In 1931 gold redemption was again suspended and has continued suspended to date.

The currencies of the principal British colonies and (after the first World War) of the mandated areas had long been tied

to sterling by various arrangements. Shortly before the first World War these arrangements were developed into what was known as the currency board system, wherein reserves of these dependent areas were maintained in London. Regional currency boards issued local currency against sterling paid into the board in London. Conversely the regional boards received local currency and sold sterling. This sterling exchange system operated more or less automatically and tied the colonial currencies firmly to sterling.

In addition to these formal arrangements involving currency boards and reserve requirements there was, during the period prior to 1931, a loose system which linked most of the currencies not only of the Empire but of several other countries as well to the pound sterling. A large part of the monetary reserves of this group of independent and semi-independent countries was voluntarily maintained by their central banks in London in sterling, either in cash or invested in Treasury bills. In addition to these secondary reserves held in London by the central banks of Empire and other countries, commercial banks of practically all countries also maintained balances there. Sterling, as noted above, was widely used and readily accepted in foreign trade transactions throughout the world, so that banks found it useful to maintain funds in London in connection with their international transactions. The importance of the London commodity market and the facilities which London offered for financing commodities contributed to make the pound sterling in effect an international monetary unit.[1]

The Sterling Bloc.—Prior to the depression of the 1930's this financial and trading system that centered in London operated smoothly and without a name. When the pound sterling, however, weakened as a result of the heavy withdrawal of funds from London (about one billion dollars in a few months, met by the export of only about $100 million of gold), departed from gold in 1931, the countries that had linked their currencies to the pound were confronted with a problem. Sterling was no longer convertible into gold, and the gold value of the sterling

[1] See Chapter 4 for a discussion of London as a financial center.

reserves of these countries became immediately depreciated. As regards currency policy these countries could permit their own currencies to follow sterling in its downward course, or they could attempt to maintain the parity of their currencies with gold.

The Empire currencies that were formally on the sterling exchange standard had no choice and continued the fixed tie to sterling. To them there was in fact little change in the situation since their foreign transactions were largely in terms of sterling. The Dominions, with the exception of Canada, Newfoundland, and South Africa, decided to remain with sterling. A large share of their reserves was in sterling, and insofar as they were exporters of primary products the prices of which had fallen, they did not object to seeing sterling depreciate; their exports sold on the world market in terms of gold would then yield more sterling. The Scandinavian and other countries that maintained especially close relations with sterling and held reserves in London also depreciated along with sterling. As a practical matter they had little choice. Canada, Newfoundland, and South Africa (a large gold producer) decided to remain on the gold standard with the United States dollar.

The name "sterling bloc" came to be applied to those countries whose currencies, depreciated in terms of gold, were in varying degrees pegged to sterling, and whose monetary reserves were held in large part in sterling funds. The sterling bloc was in contrast to the gold bloc which consisted of countries remaining on the gold standard. The two criteria, a peg to sterling and maintenance of reserves in London funds, were generally considered as measures of membership in the sterling bloc. The group grew in size and included such non-Empire countries as Portugal, Egypt, Iraq, Siam, the Scandinavian countries, Finland, Greece, and Iran, more or less in the order of degree of attachment to sterling. Japan, Argentina, and Bolivia were on the fringe of the sterling bloc. Within the Empire, Canada, New Foundland, Hong Kong, and South Africa remained outside the sterling bloc.

An important feature of the sterling bloc arrangement was that sterling was freely convertible into dollars, gold, or other

currencies at the prevailing market exchange rates. This feature was a significant attraction to members. The sterling bloc countries were interested not only in stable exchange rates with sterling, but also in stability with reference to nonsterling currencies. Through operations of the Exchange-Equalization Account, established in 1932, fluctuations of the pound and the currencies tied to it with gold currencies were narrowed but not eliminated entirely. The use of sterling as a base for this widespread sterling exchange standard, while it strengthened sterling, also placed a responsibility on British financial authorities, since Britain in effect held the central reserves for the entire bloc and might be called upon to provide gold or foreign currencies for payments outside the group. Stabilization of the entire bloc against gold currencies, insofar as possible, was a responsibility that devolved upon Great Britain.

The Sterling Area and Dollar Pool.—When war broke out in 1939 the sterling bloc came to an end and was replaced by what is known as the sterling area. The sterling area is in several significant respects dissimilar to the sterling bloc. Free convertibility into dollars, gold, and other outside currencies was abandoned upon the outbreak of war and exchange controls were instituted for the entire group. The sterling area became a joint exchange control system, based on the pound which was no longer convertible. Membership in the sterling area involves formal arrangements, not the case in the sterling bloc, and the assumption of obligations as well as privileges, which was also not the case in the sterling bloc. Members of the Empire, with the exception of Canada and Newfoundland, have modeled their exchange control systems on that of the United Kingdom, so that there is the appearance of a single exchange control system for the Empire. There are, however, many separate exchange control authorities operating largely independently of London. The exchange control systems of the other members of the sterling area are also similar.

A significant feature of the sterling area is the exchange or dollar pool as it is called. Members agreed to pool, under the

management of the Bank of England, specified currencies, particularly United States dollars, and to receive sterling in exchange. They can draw against this central pool as needed to pay for imports from outside the sterling area, but have agreed to limit such drawings to those for strictly essential purposes. The members further have agreed to purchase their imports within the sterling area insofar as possible in order to conserve outside exchange. Payments within the area are relatively free. Exports to outside areas are, of course, encouraged. London is thus a clearing center for payments within the sterling area. Most of the sterling area exchange settlements with countries outside the area are also centered in London.

While transfers within the sterling area are relatively free, which is the principal advantage of membership, there have been limits on the amount of purchases that can be made by one sterling country in another because of certain commodity shortages. These limitations were extensive during the second World War and were enforced by export controls, raw material and shipping allocations.

In order to prevent foreign exchange from leaking out of the area for unauthorized purposes a system of special accounts for funds held in London has been established. These special sterling accounts, arranged generally between the Bank of England and the central banks of the various countries, make possible supervision over the use of the sterling accumulated in London. Sterling held in these different accounts can be used with considerable freedom within the sterling area, but in most of the accounts the funds are subject to rigid control with respect to conversion into outside currencies. Transfers between most of the accounts are restricted to prevent improper use of the funds, especially since holders of sterling in the American accounts are allowed special privileges of conversion.

United States exporters to the sterling area are permitted to convert their sterling into dollars rather than be compelled to spend it within the sterling area or to retain it as so-called blocked sterling. According to the "cash and carry" provisions of the United States Neutrality Act of 1937, American exporters

were not allowed to sell to a belligerent on credit, so that during the early part of the war Great Britain was compelled to find dollars for her American purchases. This was done in three ways: (*a*) through the export of goods and services by Great Britain and other members of the sterling area, (*b*) through the sending of gold (both accumulated and new) to the United States, and (*c*) through the sale of British foreign assets. The inauguration of lend-lease operations under the Law of March 11, 1941, whereby the United States Government was empowered to advance defense materials to Great Britain and other countries, eliminated the urgency of finding dollar exchange.[2]

After the end of the war some of the sterling area arrangements were modified. Several of the members placed restrictions on trade and payments within the sterling area, requiring licenses for such transactions. These restrictions, however, were usually less severe than those applying to nonsterling area transactions. Some of the countries retained a small portion of their gold and dollar receipts instead of contributing it to the central pool. In general, however, members of the sterling area continue to pursue common policies, particularly with respect to licensing of imports and allocating exchange for payments for other transactions, and also continue to pool practically all of their gold and dollars receipts.[3] Residents outside the sterling area are able to use their sterling accounts for payments within the sterling area or to transfer, i.e., to sell the sterling to other residents of their own country. The transferability of such

[2] Until the middle of 1940 American creditors were able to withdraw funds from the sterling area through the so-called free sterling market. In this market sterling that was owned abroad could be freely sold for dollars at rates which fluctuated widely and which, of course, represented more depreciation of sterling than the official rates. Such sterling could be used to withdraw investment funds from Great Britain. This condition ended when Great Britain tightened the restrictions in 1940. Exports thereafter to the United States and Switzerland had to be paid for in dollars or Swiss francs, or in sterling bought at the official rates. League of Nations, World Economic Survey 1939-1941, Geneva, 1941.

[3] The sterling area in 1951 consisted of the United Kingdom with the British Colonies and Protectorates, Australia, Burma, Ceylon, Iceland, India, Iraq, Ireland, New Zealand, Pakistan, and the Union of South Africa.

sterling to residents of other nonsterling countries, however, is not always permitted. The arrangement varies with the type of account. Holders of American accounts sterling continue to have wide freedom in the use of their sterling, being able also to convert it freely into dollars.

Sterling Balances.—One of the significant aspects of the British wartime exchange arrangements was the large accumulation of sterling balances in London by members of the sterling area and other countries. These balances resulted from the heavy imports by the United Kingdom from sterling area and other countries in connection with the conduct of the war, and the obvious inability of the United Kingdom to export adequately to pay for these imports. Most of these balances consisted of sterling holdings of central banks and exchange control authorities in their London accounts. At their peak, in 1945, the balances amounted to about 3.5 billion pounds, the equivalent of approximately $14 billion at the rate of exchange then prevailing. The balances of some of the countries declined during the following years, while the balances of certain other countries increased. The increases were partly the result of the inflow of capital following devaluation of the pound in 1949, and of the rise in the prices of raw materials after the beginning of the Korean War in June, 1950.

The increase in Britain's gold and dollar reserves since 1949 has been accompanied by an increase in balances in London as sterling area earners of dollars have turned over their dollars in exchange for sterling. On the basis of the devalued pound, the balances in early 1951 amounted to the equivalent of about $9 billion, of which about $3.6 billion (£1,300 billion) were held in blocked accounts. The balances have continued to increase.

The British government has undertaken the negotiation of long-term agreements for the liquidation of balances not needed as working reserves held in London. With the growth of Britain's foreign trade, however, larger working balances are needed. Some of the balances are to be used to finance economic

development.[4] Sterling balances are expected to contribute to the financing of the Colombo Plan for the economic development of South and Southeast Asia to the extent of about £300 million, which is about one-third of the estimated foreign exchange costs of the Plan.

Had a lend-lease or mutual aid program, such as was adopted by the United States and Canada, been in effect in the sterling area countries during the second World War, these large balances would not have accumulated. Each country would have contributed goods for the conduct of the war and not expected payment by the United Kingdom. The largest holder of the balances by far was India, followed by Egypt, Australia, etc. India's sterling was the result in large part of expenditures by the United Kingdom in India for troops and installations, as well as for commodities imported into the United Kingdom, converted at fixed exchange rates between the pound and rupee.

These accumulated balances were frequently referred to during and after the war as blocked balances, which was somewhat of a misnomer since, although generally not convertible, they were usable for certain purposes. They could all be invested in British government securities, and those which were not blocked could be spent freely within the sterling area.

After the war, with the United Kingdom running a sizable deficit in her international accounts, and with her economy badly shattered, the large accumulation of sterling balances created a problem. It was assumed in some quarters that these balances, or war debts, would be substantially scaled down or perhaps written off, as representing the contribution of these countries to the war effort. However, their owners, in large part countries with low standards of living, were not so inclined and insisted on payment in full. The British government did not deem it expedient to press these countries immediately after the war, and since the international political situation deteriorated

[4] The agreement with India provides for the release of India's blocked sterling balances during the six years beginning July 1, 1951, in the total amount of £210 million. Approximately £35 million are to be available each year, although the annual amount may be increased or decreased by agreement.

in the ensuing years, Britain became less able to arrange settlements involving reduced payments. India, the largest creditor, needed British goods, and moreover, the communist threat there and elsewhere was great. Britain accordingly began to liquidate these balances through permitting their expenditure for British exports rather than to seek their reduction through cancellation in whole or in part.

Another aspect of the problem was the desire of certain British exporters to assure themselves of a protected market for their exports. So long as these countries possessed sterling balances which were inconvertible into dollars, and expendable only in the United Kingdom, or sterling area, British exporters would find a ready market for their exports. Even though immediately after the war British exporters had a strong market for the limited amount of goods then available for export, they saw in the balances an assurance of a continuing market for their exports, with competition from the dollar area restricted.

The United States, even before the end of the war, was aware of the possible discriminatory use of inconvertible sterling balances. The United States believed that an expansion of trade and living standards throughout the world would be furthered most effectively by establishment of a nondiscriminatory and relatively free multilateral trading system. Sterling balances that were usable by their owners only in the United Kingdom and sterling area were inconsistent with such a system. The United Kingdom on the other hand, although agreeing in principle with the United States objective,[5] was wedded to a policy of extensive government regulation of the details of the country's economy, including foreign trade. When a government participates in the conduct of foreign trade or influences its nature and direction for balance of payments or other reasons, discrimination is almost inevitable. Many persons in the United Kingdom, moreover, believed that without the aid of discriminatory devices British exports would be unable to compete effectively against United States goods. This subject is discussed further in Chapter 34.

[5] See discussion regarding United States proposals for expansion of world trade and employment, Chapter 20.

When the United States extended a loan of $3,750 million to the United Kingdom in 1946, a provision was inserted in the agreement, with the sterling balances in mind, to the effect that no part of the money was to be used to repay any other creditors of the United Kingdom. When, by the summer of 1947, the loan was largely used up and at the same time the sterling balances showed a substantial reduction, it was questioned in some quarters whether the loan agreement had been carefully observed. However, once loan dollars were made available to the United Kingdom they became indistinguishable in practice from dollars earned by exports, so that no precise answer could be given. It was clear, nevertheless, that Great Britain had been generous in releasing accumulated sterling balances, as well as in making dollars available to members of the sterling area. During these two years, 1946 and 1947, the sterling balances were reduced by slightly over 200 million pounds, and dollar pool resources declined by about 150 million pounds.

Exports that represented payment of these balances or that represented the export of capital were commonly referred to as "unrequited exports," since they earned no foreign exchange. For them, however, Britain received debt reduction, a certain amount of employment at home, extension of aid to the Empire and Commonwealth, and some foreign investment. They were, however, a factor in the troublesome deficit in Britain's international accounts. Not all of such exports, of course, could have been made to earn gold or dollar exchange had they not been used to repay the balances or to provide for capital outflow, but some of them could.

Sterling After the War—Devaluation.—The end of the war found Great Britain's economy including its foreign trade seriously disrupted. The country was in urgent need of imports, yet had only limited amounts of foreign exchange resources and gold to pay for such imports. The export trade was a fraction of its former amount and large deficits existed in the balance of payments. The annual income received from overseas investments had declined from approximately £155 million in 1938 to £116 million in 1948. This decline was thus not

as serious a factor in the balance of payments as sometimes represented. The nominal value of British overseas investments is estimated by the Bank of England to have declined from £3,545 million in 1938 to £1,960 million in 1948. British overseas indebtedness increased during this period by more than the value of the remaining assets, so that Britain has become a net debtor on total account.[6] The liquidation of foreign investments during this period yielded £1,244 million in cash.

Some of Britain's former export markets, such as Germany, were temporarily destroyed by the war, or in other cases were more or less permanently lost because of the development abroad of competing production. Costs of production had risen in the United Kingdom and caused British exports to be expensive, especially at the official exchange rate of $4.03. Furthermore, British productive capacity had to a large extent been converted to the production of war goods and needed reconversion, and had also been severely damaged by the destruction of war. British industry needed considerable modernization in order to compete effectively.

The United States Government in 1946 granted Britain a loan of $3,750 million, in order to assist British reconstruction and to help the country obtain necessary imports, meet balance of payments deficits, and thereby facilitate the restoration of convertibility of the pound and the liberalization of trade. This loan, specifically authorized by Congress, was granted after extended discussions between officials of the two governments regarding the kind of international financial and trading relations which should be sought. The United States was fearful lest the sterling area survive as a more or less permanent monetary bloc which would be discriminatory against the United States and other dollar area trade. The United States believed, as noted above, that an advancement in world production, trade and living standards would be promoted best by the establishment of a relatively free and nondiscriminatory single multilateral trading system wherein currencies were freely convertible, one for the other. These objectives were set forth in the

[6] Bank of England, *United Kingdom Overseas Investments, 1938 to 1948* (London: Bank of England, 1950).

statement published by the United States Department of State entitled Proposals for the Expansion of World Trade and Employment, to which the British government subscribed.[7]

One of the provisions of the loan agreement was to the effect that not later than one year subsequent to the agreement the sterling receipts from current transactions of all sterling area countries should "be freely available for current transactions in any currency area without discrimination."[8] The sterling receipts from current transactions with the United States became freely available, according to the agreement, immediately after the agreement entered into effect. General convertibility for current transactions was undertaken in July, 1947, as provided in the agreement. Britain, however, was able to maintain convertibility for only a short time due to a number of factors. The continuing balance of payments deficits, the release of sterling balances and of dollars to the sterling area, the export of British capital, and the $4.03 exchange rate which overvalued the pound did not provide a background which would permit a continuously convertible pound. Convertibility was suspended in August, 1947, for countries generally, although the proceeds of exports from the United States to the United Kingdom and sterling area remained convertible into dollars.

During the war and until 1949 the United Kingdom had maintained the exchange rate for the pound at approximately $4.03. Transactions in foreign countries, beyond the control of the British government, however, took place at lower rates. As reconstruction proceeded and output substantially recovered, Britain's balance of payments position remained unsatisfactory. It became clear to many persons throughout the world that Britain could not balance accounts, particularly on a relatively free basis, at the $4.03 rate of exchange. Nevertheless the British government was reluctant to consider devaluation.

Arguments offered in defense of the prevailing rate were first that the country was exporting all that could be exported and did not lack export markets, so that a cheaper pound would not

[7] See Chapter 20.

[8] *Anglo-American Financial and Commercial Agreements,* Department of State publication 2439, Commercial Policy Series 80.

promote additional exports, but would, on the contrary, reduce the dollar value of existing exports. This argument of price inelasticity of exports, and also of imports, has been used in many countries against devaluation. It was also argued that a cheaper pound would raise the price of imports, particularly food which was especially important in the United Kingdom, and that the cost of living would therefore rise materially, contributing to inflation.

On the other hand, it was noted that British exports were going excessively to nondollar countries, i.e., to "soft currency" countries, indicating that in terms of dollars British goods were not satisfactorily meeting price competition. The decision to devalue was forced on the government by the widespread views throughout the world that devaluation was necessary and inevitable, and the consequent withholding of orders (i.e., decline in British exports) pending such devaluation. British gold and dollar holdings declined seriously during the first part of 1949.

Finally, in September, 1949, in consultation with the International Monetary Fund as required by the Fund, the pound was devalued to $2.80 which was more drastic devaluation than was generally anticipated. Certain countries of Europe, which would feel British competition, were displeased over the low level adopted. Subsequent events proved the wisdom of devaluation. Costs in Britain were brought into line so that exporters were better able to compete, and within a few months British earnings of gold and dollars rose sharply and the balance of payments position was greatly strengthened. In 1950 Britain's international accounts no longer showed a deficit, and the sterling area, as a whole, earned a surplus of dollars, thereby resulting in an increase in gold and dollar reserves.

The improvement in Britain's balance of payments position and general economic condition was sufficiently great that E.C.A. aid from the United States was suspended, as of the first of 1951. From the beginning of the E.R.P., total E.C.A. aid amounted to $2.7 billion. Dollars from the United States military assistance program, of course, continued to accrue to Great Britain.

It was realized in the United Kingdom and elsewhere that

if London and the pound sterling were to regain their central position in the trade and finance of the world, and not merely in the sterling area, the pound must again be freely convertible. The accumulated balances overhanging the exchange market, and the effect of convertibility on the sterling area system, however, bulked large when discussions of convertibility took place. Even though Britain's exchange resources increased substantially during 1950, Britain was reluctant to take measures which might weaken her exchange position, or interfere with the sterling area system. She finally participated in the European Payments Union on a basis satisfactory to all, although she had been hesitant.

In spite of strengthened gold and dollar reserves and a surplus in the balance of payments, Britain did not wish to relax materially her exchange restrictions. A large body of thought in the United Kingdom has long favored more or less permanent continuation of the discriminatory restrictions and inconvertibility, which are the backbone of the sterling area system. These measures, supported by tariff preferences, provide a protective wall around the sterling area for British products. Holders of sterling thus buy to a large extent within the sterling area.[9]

The International Monetary Fund in connection with its responsibilities under the General Agreement on Tariffs and Trade (Article XV, 2), made a finding late in 1950 to the effect that certain sterling area countries, Australia, Ceylon, New Zealand, Southern Rhodesia, and the United Kingdom, were individually in a position to undertake progressive relaxation of exchange restrictions against dollars and other hard currencies. This view was urged by Belgium, Canada, Cuba, and the United States. The United Kingdom, however, opposed this finding and urged that the sterling area must be viewed as a whole, and that the finding gave insufficient weight to adverse factors

[9] For a discussion of the reasoning behind the British partiality to discriminations, bilateralism, etc., and the reasoning behind United States adherence to liberal multilateralism see Chapter 34, "United States Foreign Economic Policy."

expected to operate in the future in connection with rearmament. The view of the Fund was not pressed and no major relaxation ensued.

The rearmament program following the invasion of Korea, and the resulting rise in prices of raw materials benefited the foreign exchange position of sterling area raw material exporters, but increased the cost of rearmament to Great Britain. The rearmament program also necessitated certain controls to allocate scarce materials and to redirect resources toward meeting military needs. At the same time the rearmament program emphasized the need for trade liberalization and European economic integration in the interests of efficient use of resources and maximum production, and that restrictions which did not contribute to military needs should be viewed with suspicion.

The International Monetary Fund in its Second Annual Report on Exchange Restrictions issued in May 1951 said: "The improved position of sterling and the demands for Sterling Area commodities have meant the rapid reduction of the 'overabundance' of sterling. Working against this general improvement are the increasing liabilities in sterling which the United Kingdom is incurring to various segments of the Sterling Area as a result of U. K. imports and the acquisition by the Exchange Equalization Account of gold and dollars earned by other sterling countries. But countries are now much less anxious to dispose of their sterling holdings, and there is much less willingness on the part of holders of sterling to offer it for sale at considerable discounts than was previously the case. The greater demand for sterling has facilitated the developing settlement of the sterling balance problem. To the extent that the holders of these balances now want to hold them, the problem tends to disappear. In the latter part of 1950 and early 1951, arrangements were being worked out to release or settle over a period of years a number of large holdings of sterling balances which had accumulated during the war." [10]

[10] International Monetary Fund Second Annual Report on Exchange Restrictions, April 1951.

The Bank of England.—The central institution in the sterling area as well as in British finance generally is the Bank of England, the oldest central bank in the world. In 1691, William Paterson prepared a project for a bank that would be similar to the strong banks on the Continent that by that time had already become well established. These included the Bank of Amsterdam, founded about 1608 or 1609 (liquidated in 1790), the Bank of Venice, founded in 1619 (discontinued in 1806), and the Bank of Genoa which traced its early beginnings to 1148 in the form of a company created to make a loan to the republic. The exact date when the Bank of Genoa began to do a banking business is not entirely clear. The Bank failed in 1797 and passed out of existence.[11]

At the time of Paterson's proposal the English government of William III was in need of funds to prosecute the war against France. Finally, in 1694 Parliament passed a law known as the Tonnage Act which provided for the Bank. It was to be a joint-stock company known as "The Governor and Company of the Bank of England," still the official title of the Bank. The Bank was to make a loan of £1,200,000, its entire capital, to the government at the rate of 8 per cent.[12] The Bank was allowed to receive deposits, issue notes payable upon demand, and make loans. It was entirely a private institution, although close to the government from the very beginning. In 1709, the Bank was given a monopoly of note issue in England, but in 1826 joint-stock banks were allowed to issue notes at a distance of 65 miles from London.

The Bank had a wholesome effect upon business. It helped to stabilize exchange rates, assisted in the marketing of the government's annuities, and loaned money to the community upon reasonable rates of interest. The Bank successfully weathered the financial crises of 1763, 1772, and 1783, but in 1797 was forced to suspend specie payments for an extended period.

[11] Harvey E. Fisk, *English Public Finance* (New York: Bankers' Trust Company, 1920).

[12] As the charter was renewed from time to time the loan to the government was expanded and at present amounts to £11,015,100. In 1844, the charter was extended for an indefinite period, terminable upon one year's notice and repayment of the debt by the government.

England was drawn into war against France in 1793. The Bank at that time was in a strong condition, but as William Pitt, Chancellor of the Exchequer, made demands upon it and as it made large loans to the government and accordingly increased its note issue the Bank's cash reserve began to be depleted. In 1797, a run on the country banks took place because of fears of a French invasion. The country banks thereupon drew down their balances with the Bank of England, so that its specie reserves declined rapidly. The Bank Restriction Act was therefore passed that year, prohibiting the Bank from paying out specie, with a few exceptions, and making its notes receivable for taxes. Bankers and merchants assembled and passed a resolution agreeing to accept the notes freely.

Not until 1819 was the Restriction Act repealed, when provision was made for resumption of specie payments by the Bank in 1821. From then until 1914 the notes continued redeemable in gold, although the Bank passed through several difficult periods.

The present form of the Bank of England dates from the Peel Act of 1844. This Act divided the Bank into two departments, the Banking Department and the Issue Department. The division is principally a matter of bookkeeping. The duties of the Issue Department are of a routine nature and consist of issuing notes and holding the security behind them. If the Banking Department wants more notes it receives them from the Issue Department by turning over gold or proper assets. Under the Peel Act the Bank was required to hold against all notes it issues, coin or bullion,[13] to the extent of 100 per cent, with the exception of a fixed fiduciary issue against which government securities are to be held. The fiduciary issue was limited by the Peel Act to £14,000,000, which was the debt of the government to the Bank at the time of the Act, £11,000,000 of this amount being the perpetual debt to the Bank. Whenever any of the joint-stock banks gave up their right to issue notes, the Bank of England could increase its fiduciary issue to the extent of two-thirds of the lapsed issue. In this way the uncovered issue

[13] One-fourth of the metal may be silver, but the Bank ceased holding silver as security for notes in 1853.

gradually increased, the last private bank giving up its issue in 1923.

In August, 1914, the Currency and Bank Notes Act was passed which, in addition to providing for the issue of notes of £1 and 10s by the Treasury, gave the Treasury authority to suspend the Bank Act, thereby permitting expansion of the fiduciary issue beyond the fixed amount. Such expansion was not allowed to take place, however, except temporarily (it does not show in any bank statement since the situation was remedied before a statement was issued), and the bank notes continued to be backed fully by gold except for the limited fiduciary issue.

Great Britain returned to the gold standard in 1925, but specie payments were resumed by the Bank only in amounts of not less than 400 ounces of gold. The next change in the Bank came in 1928 when the Currency and Bank Notes Act of 1928 provided for the taking over by the Bank of the currency notes of £1 and 10s issued by the Treasury, together with the assets behind them. The fiduciary issue was thereupon greatly increased and fixed at £260,000,000, with the provision that the issue could be raised or lowered with the consent of the Treasury for a period of six months, the period being renewable during two years.[14]

The possible increase of the fiduciary issue when conditions make this desirable provided needed flexibility in the currency. The former system was too inelastic and unadapted to changing economic conditions. The present system is still somewhat rigid in comparison to that of America, Canada, and other countries, but is an improvement over the former arrangement under which the Bank in emergencies had been compelled to break the law.

In January, 1939, the Bank of England transferred £200,000,000 of its £327,000,000 of gold to the Exchange Equalization Account, discussed below, which paid for it with govern-

[14] In order to cope with the banking crisis in the summer of 1931, the fiduciary issue was expanded to £275,000,000 on August 1 of that year. When the Treasury permission for this increase finally expired on March 31, 1933, the Bank did not again ask its renewal, the fiduciary issue being reduced to the regular figure of £260,000,000.

ment securities. The fiduciary circulation was thus increased from about £230,000,000 to about £400,000,000. At the same time the Chancellor of the Exchequer submitted a bill to Parliament which provided for the revaluation of the Bank's gold holdings. The United States, France, and other countries had previously devalued their currency in terms of gold, and had accordingly written up the value of their gold. This measure, which received the Royal Assent on February 28, 1939, provided that the Bank's gold was henceforth to be valued weekly at the market price, which was then approximately 148 shillings per fine ounce, instead of the statutory price of 84 shillings 10½ pence. If the Bank's gold were in the future to increase in value, the Bank was to pay the profit into the Exchange Equalization Account, while if the value were to decline, the Account would reimburse the Bank. After the adoption of the bill the Bank's remaining gold was written up and the fiduciary circulation correspondingly reduced. The Bank's official buying price for gold was increased on a number of occasions, and was raised to 248 shillings in September, 1949.

After war broke out, the government announced in September, 1939 that it was transferring about £280,000,000 in gold from the Bank to the Equalization Account. This action entailed an increase in the fiduciary note issue from approximately £300,000,000 to £580,000,000, and left the British currency almost entirely unbacked by gold. As the war progressed the circulation of the Bank was expanded from time to time. In April, 1951, it amounted to £1,280,000,000 being slightly below its peak of £1,450,000,000 reached in 1946.

Although the Bank of England was entirely privately owned and managed until 1946, it was always close to the British government and recognized its responsibility as the central bank of the United Kingdom. Its duty of regulating the currency and credit system in the general interest was placed ahead of the aim of earning a profit for stockholders, although the Bank earned good profits.

In February, 1946, the British government provided for the nationalization of the Bank, which became a government institution on March 1, 1946. The governor, deputy governor, and

other members of the court of directors (16) are appointed by the King. It is an unwritten law that none of the directors (formerly 24) shall also be a director of one of the large joint-stock banks. The Treasury (under the Act of 1946) is empowered to give such directions to the Bank, after consultation with the governor, as it considers in the public interest. The government compensated former stockholders in government bonds bearing 3 per cent interest in an amount sufficient that the stockholder would receive interest on the bonds equivalent to the average dividend on his stock during the preceding twenty years. When the Bank was privately owned each stockholder was allowed only one vote regardless of the amount of his holding, provided it was at least £500.

One of the ways in which the Bank controls the money market and protects the British currency system is through its rate of discount, the so-called "Bank rate." This is the rate at which the Bank buys approved bills from its customers, or in other words supplies funds to the market. To be eligible for discount at the Bank of England a bill must bear at least two good British names, of which one must be the acceptor. If the Bank feels that market rates are too low and that lending is going on too freely (and prior to 1931 that perhaps as a consequence gold was leaving the country too rapidly and foreign exchange was under pressure), the Bank may raise its rate of discount, the rate at which it will lend money.

The joint-stock banks do not borrow directly from the Bank of England. They maintain sizable secondary reserves in the form of call loans to the bill brokers or dealers which are secured by acceptances. If the joint-stock banks needs more cash, they call their loans from the bill brokers, who are thereupon forced to borrow at the Bank of England, paying the rate which the Bank has established.

The Bank rate is ordinarily maintained higher than the market rate for the same class of paper. The rate is, therefore, not much of a factor unless there is a stringency in the money market. It is in the nature of a penalty rate and discourages undue borrowing. The Bank, however, is prepared to grant to borrowers, at its rate, all the funds to which they are entitled.

If the market has plenty of money so that the higher Bank rate is ineffective, the Bank of England may engage in open-market operations; that is, it may send its agents out to sell securities in the market, withdrawing the proceeds, or perhaps it will borrow from the market giving government obligations as security. This action may force the joint-stock banks to call their loans and the bill brokers thereupon to borrow at the Bank of England. The higher rates and the withdrawal of funds from the market by the Bank may cause an inflow of money from abroad. A lowering of the rate, on the other hand, tends to have the opposite effect, to make money easy. The Bank can supplement a lower rate, in case the lower rate is not sufficiently effective, by buying securities from the market.

The effectiveness of the Bank rate is strengthened by the practice of the banks of basing their deposit and loan rates upon the Bank rate. Thus the rate of interest paid by London banks is usually 2 per cent below the Bank rate. The psychological effect of Bank rate changes is also important as a control device.

A few days prior to the outbreak of the second World War the Bank raised its rate (August 24, 1939) from 2 per cent to 4 per cent, as had been the historic custom in periods of war and crisis, the reason being to discourage the rush to liquidity and to check unnecessary credit expansion. The move was severely criticized by John Maynard Keynes and other disciples of low interest rates, who urged that the war be financed with cheap money. In September the rate was lowered to 3 per cent and in October, back to 2 per cent, where it has remained to the present time.

Exchange Equalization Account.—The suspension of gold payments in 1931 left the pound open to wide fluctuations and a prey to international speculation and other erratic influences. To counteract these forces and to provide a measure of stability, the Issue Department of the Bank of England bought and sold foreign currencies and gold. It entered the exchange market as either buyer or seller, i.e., on the demand side or supply side, according to whichever seemed appropriate. It soon became evident, however, that the resources of the Bank were not suffi-

cient to smooth out fluctuations in sterling without the assumption of more risk than appeared wise. Consequently, in April, 1932, a special Exchange Equalization Account was voted by the government, and began operations in June, 1932. It was originally limited to £175,000,000, plus £25,000,000 from the former dollar exchange reserve, but in May, 1933, after the United States left gold, the amount was increased to a total of £375,000,000 when the House of Commons voted an additional £200,000,000. It was subsequently increased still further.

The effects of gold imports or exports upon bank reserves were offset by operation of the Exchange Equalization Account. When it bought gold it sold Treasury bills, and the money received for the bills was withdrawn from the market, thereby offsetting the money paid out for the gold. Conversely, when gold left the country the Account bought Treasury bills, thereby putting cash into the market. Its operations in gold were balanced by its operations in Treasury bills, so that the market neither gained nor lost any cash.

As noted above, in January, 1939, £200,000,000 in gold was transferred from the Bank of England to the Account, which paid for the gold with government securities. The gold which remained in the Bank was then revalued and the profit given to the Exchange Equalization Account. The Account had already followed the practice of valuing its own gold holdings according to the market value. This gold operation, following the practice of the United States and other countries, utilized the profits from gold devaluation for exchange stabilization.

When war broke out the Account promptly withdrew support from the pound, which had been maintained at approximately \$4.68. The pound then depreciated rapidly, but was soon officially pegged at about \$4.02½—\$4.03½. On September 1, 1939, the Currency (Defense) Bill was passed, which provided that the resources of the Exchange Equalization Account were available for war purposes. The Chancellor of the Exchequer announced a few days thereafter that £280,000,000 in gold was being transferred from the Bank of England to the Account. The Account's resources were drawn upon to help pay for goods purchased abroad, especially in the United States.

During the period of its active stabilization operations the Account was successful in reducing fluctuations of the pound. The Account, however, did not attempt to interfere with a general trend one way or the other. To undertake to do this and go against a lack of equilibrium in British foreign payments, perhaps of a fundamental nature, would have been difficult and expensive, if not ultimately fatal to the Account. Operations of the Account, managed by the Bank of England, were necessarily kept secret.

The Exchange Equalization Account now holds practically the entire gold and dollar reserves of the United Kingdom, which are also the reserves of the entire sterling area. At the 1st of April, 1951, these amounted to £3,758,000,000, an increase of £458,000,000 since the first of the year. The gold in the Bank of England amounted on that date to only £400,000. Inasmuch as the pound is now rigidly fixed at $2.80 the present operations of the Account are largely of a mechanical nature.

Chapter 24

MONETARY AND EXCHANGE PROBLEMS—POSITION OF GOLD

Postwar Disequilibrium—the "Dollar Shortage."—Since the early days of the depression of the 1930's much of the world has experienced more or less continuous balance of payments difficulties, which have taken the form principally of deficits in current transactions. The deficits were especially severe during the first few years after the second World War, but declined or disappeared entirely following the devaluations in the fall of 1949 and the rearmament program after the invasion of Korea in June, 1950, when United States imports increased materially. The total of all deficits must, of course, equal the total of all surpluses (an export from one country is an import to another) and the large United States postwar surplus accounted for the deficits of many other countries. United States imports, as well as exports, increased substantially during and after the war, and the large surplus reflected the strong world-wide demand for United States goods rather than a diminution of United States imports. As a result of the deficits there was a widespread shortage of foreign exchange, particularly of United States dollars and other so-called hard or convertible currencies. The terms "dollar shortage" and "dollar gap" were used to describe this situation.

In 1947, United States exports of goods and services reached the peak figure of $19.798 billion, whereas imports of goods and services amounted to only $8.289 billion, leaving a difference of $11.509 billion. This figure was sharply reduced during the following three years, and by the first of 1951 United States merchandise exports and imports were approximately equal, with both exports and imports continuing to increase. The

deficits were financed largely by loans and grants from the United States and by drawing on such gold and foreign balances as these countries owned. Marshall Plan aid accounted for a substantial portion of the funds which the United States provided to meet Europe's dollar deficiency during the critical postwar years. The extent of the postwar United States surplus is shown in the accompanying table.

TABLE 9

UNITED STATES BALANCE OF PAYMENTS, JULY 1, 1945, to JANUARY 1, 1951
(In millions of dollars)

Period	Total Exports of Goods and Services	Means of Financing			
		Total Imports of Goods and Services	U. S. Government Sources (net) *	Liquidation of Gold and Dollar Assets †	Other ‡
Total Postwar	$89,137	$51,608	$29,755	$2,471	$5,303
1945—July-Dec.	7,201	4,143	3,629	−1,077 §	506
1946—Jan.-June	7,235	3,328	2,569	823	515
July-Dec.	7,506	3,635	2,408	1,109	354
1947—Jan.-June	10,068	4,091	3,327	2,378	272
July-Dec.	9,728	4,198	2,515	2,084	931
1948—Jan.-June	8,806	4,980	2,302	854	670
July-Dec.	8,286	5,376	2,766	− 74 §	218
1949—Jan.-June	8,765	4,968	3,337	364	96
July-Dec.	7,191	4,747	2,610	− 362 §	196
1950—Jan.-June	6,793	5,278	2,267	—1,134 §	382
July-Dec.	7,558	6,864	2,025	—2,494	1,163

* United States Government sources (net):
(a) Data in the above table are net of unilateral transfers to the United States, capital repayments, etc.
(b) Pensions, annuities, claims against the United States Government, etc., are included in this calculation of net sources.
(c) Also included in the calculation of net sources are loans and property credits. The latter are entered at the time the property was actually transferred.

† Figures in the above table differ from those which could be derived from other sources principally because this table includes gold sold out of current production abroad, as well as liquidation of foreign long-term capital assets in the United States.

‡ Included in this category are net dollar disbursements by the International Monetary Fund and the International Bank, United States net private remittances, United States net private long- and short-term capital outflow, and errors and omissions.

§ Negative figures are due to the net foreign acquisition of dollar assets and purchases of gold from the United States, which are a result of an excess of the means of financing over United States exports.

(Source: Principally National Advisory Council on International Monetary and Financial Problems, Semiannual Report for the Period April 1, 1950—September 30, 1950.)

The balance of payments difficulties of the past two decades have been due first to the dislocations of the depression, which gradually merged with the trade distortions caused by the growth of trade barriers and the bilateral and autarkic policies pursued during the years prior to the outbreak of war in 1939; to the disruptions of the war itself; to the extensive maladjustments left in the wake of the war and centering around monetary inflation, destroyed productive facilities, and dislocated trade channels; and finally to the continuation of unrealistic exchange rates, restrictions on trade, discriminations, bilateral trading arrangements, and economic nationalism generally.

After the war the inflation of monetary incomes stimulated imports from the United States and added to the already large demand for United States goods to meet postwar needs. Furthermore, the war-devastated countries were unable to export as formerly, yet were in urgent need of goods which were available in large part only in the United States. In Latin America and other countries which escaped wartime destruction, the deficits were traceable principally to inflation, growing out, to a large extent, of the strong demand abroad for their products and the consequent expansion of their local monetary supply as a result of the conversion of the foreign exchange proceeds into local money.

In some of the underdeveloped countries the excess of imports and the resulting shortage of foreign exchange were due in part to the fact that economic development was financed by budgetary deficits which led to inflation of prices and monetary incomes. Expanded incomes stimulated imports. Exchange restrictions, which were imposed under these conditions, permitted countries to finance their development by inflation and at the same time to maintain the established rate of exchange. If a country lacking capital, it is to be noted, chooses to finance economic development by inflation, it does not necessarily follow that maintenance of the former rate of exchange is in the best interests of the country. Unless the inflation is of short duration and followed by deflation the former rate of exchange will probably sooner or later have to be abandoned.

After the long years of disequilibrium it is not surprising that balance of payments troubles should often be looked upon as normal, and of a continuing and semipermanent character. The accommodations in government measures, in production, and in the economic system generally, that were made to meet balance of payments problems, have often tended to mold trade and production in patterns that render more difficult the restoration of a relatively free balance. The institutional arrangements and vested interests which have been built up during these years of disturbance, together with the prevailing international political difficulties which extend the need for certain (but not all) restrictions, have tended to confirm the feeling in some quarters that disequilibrium is to be accepted as a normal state of affairs, and that the elimination of most exchange restrictions and other trade barriers is an unrealistic objective. From the standpoint of practical politics the difficulties of attaining this objective are formidable. A reasonably free market economy and equilibrium based thereon do not appear probable in the near future.

Exchange rate adjustments, which during the postwar period were often essential to the elimination of disequilibrium, were impeded by the widespread feeling that devaluation might entail further inflation and a rise in the cost of living, that devaluation was a sign of national weakness and reflected fiscal mismanagement on the part of the government (frequently the case), and that exchange rate stability should be maintained. Furthermore, it was frequently contended that imports and exports were inelastic and that therefore devaluation would do little to reduce imports or to expand exports unless the devaluation were drastic. There is little evidence that such inelastic conditions exist as commonly as was assumed. The mechanism of the price system and a reasonably free market were, according to this thinking, inapplicable in the promotion of balance, or would lead to excessive costs of imported commodities (a fear in general not borne out by the experience of countries which devalued their currencies close to a free market level). Extensive state management of foreign trade was thought necessary to attain a balanced condition. This philosophy has had a large follow-

ing in Europe and to some extent in the United States. The objective of equilibrium based on nondiscriminatory, reasonably free multilateral trade has been considered a theoretically desirable goal (sometimes not even this), but unadapted to twentieth-century conditions.

It was also argued that the disequilibrium and "dollar shortage" were due to the fact that the United States was technically far advanced in production over other countries, and that therefore the difficulties were chronic and that equilibrium was not possible. The fallacy in this reasoning is of course that equilibrium does not depend on equality in absolute productivity. Trade takes place on the basis of comparative costs as discussed in Chapter 10 and elsewhere.

Under a system of free currency convertibility deficits or surpluses do not exist,[1] although the rate of exchange may, of course, be quite low. The market under such conditions is constantly cleared and payments remain in balance. Such a continuous balance, however, may at times require severe internal adjustments and resulting difficulties, such as unemployment in certain industries, a rise in the prices of essential imports, windfall profits to exporters, and excessive stimulation of certain exports followed perhaps by a later decline and loss. In the effort to prevent certain evils which may result from a free market, countries, however, frequently went so far in the imposition of restrictive controls that the medicine was worse than the disease.

During the years immediately after the war, exchange restrictions, in spite of their misuse, doubtless promoted orderly exchange and trade conditions. On the positive side, from the early 1930's until the present, conditions throughout the world have most of the time been so disturbed that exchange restrictions have aided in softening the effects of the disturbances. These and related devices, however, have concealed the extent of the maladjustments which existed, and frequently delayed the taking of measures, such as the checking of inflation or the adjustment of exchange rates, which would have helped to restore equilibrium which could exist without burdensome restric-

[1] See Chapter 7 on the meaning of a deficit.

tions, in contrast to an equilibrium based on curtailment of trade. As postwar reconstruction was accomplished, and as production and trade were restored, the need for the restrictive devices became less or disappeared, but governments were, nevertheless reluctant to abandon or relax them and the protection against foreign competition which they afforded, or to undertake the exchange and other adjustments which would have facilitated their elimination.

A pattern of rates based on dislocated demand and supply was not considered, as noted above, the most desirable or politically feasible pattern, so that controlled rates were maintained. Such controlled rates, however, by stimulating imports and discouraging exports (although immediately after the war exports were frequently limited by factors other than exchange rates) added to deficits and to demands for exchange which reserves were unable to meet. Exchange restrictions were a necessary accompaniment to maintenance of the pattern of rates considered desirable during this greatly disturbed period.

Exchange restrictions are inherently discriminatory, and have been used to discriminate in favor of imports from those countries whose currencies are in ample supply and against imports from countries whose currencies are scarce, i.e., usually the United States. The United States concurred in the imposition of restrictions during the years of serious maladjustments, but sought their relaxation or removal when it believed conditions did not justify their retention. Such retention is inconsistent with United States foreign economic policy as discussed in Chapter 34.

The widespread currency devaluations which finally took place in the fall of 1949 contributed greatly to restoration of balance in the foreign trade of the countries concerned, and to the elimination of the "dollar shortage." A study by the International Monetary Fund on Changes in Trade Patterns Since the Devaluation [2] revealed that following devaluation extensive shifts in trade took place. "These shifts accordingly were

[2] *International Financial Statistics, August, 1950* (Washington, D. C.: International Monetary Fund). See also charts and comments in the December, 1950, issue.

largely in favor of the countries which devalued most and against those which did not devalue or devalued least." [3] The shift was in favor of exports from Western Europe, the United Kingdom, and the sterling area, and against the exports of the United States, Canada, and Latin America. While other factors were partly responsible for the improvement the shifts appear to be an effective answer to the contention that exchange rate adjustments will contribute little to equilibrium. The experience of Mexico in connection with its exchange adjustment about the same time was also clear evidence in the same direction. Mexico avoided the imposition of exchange restrictions to limit imports and chose devaluation instead. Her precarious reserves promptly increased and became so strong that rumors of appreciation were circulated. These developments are discussed in Chapter 41.

As a result of the Korean War which began in June, 1950, and the rearmament program, a further increase in imports into the United States took place with a consequent larger supply of dollars on the world's foreign exchange markets. The rise in the price of raw materials imported into the United States also added to the world's supply of dollars. As a result, balance of payments deficits were further relieved, reserves strengthened, and convertibility made more feasible. Countries, however, continued reluctant to relax restrictions and to move in the direction of convertibility. The Second Annual Report on Exchange Restrictions issued by the International Monetary Fund in May, 1951, as discussed in the next chapter, noted that many countries were in a position to undertake substantial removal of discrimination and relaxation of restrictions.

European Payments Union.—As postwar European reconstruction progressed, the inconvertibility of currencies, in other words the system of exchange restrictions which existed throughout Europe and most other parts of the world since the 1930's, became an increasing hindrance to the development of trade and to European economic integration. Realization of the

[3] Cf. International Monetary Fund Press Release No. 142, August 31, 1950.

objectives of the Marshall Plan was hampered by payments problems and the restrictions built up in their wake. Countries tended to have too much of one currency and not enough of another, and the inability to make payment for goods from a particular country because of lack of its currency tended to distort and narrow trade. Country A, for example, would have plenty of the currency of country B but little of that of country C. This situation caused countries to attempt to buy largely from those countries whose currency they possessed, and to balance trade bilaterally. Import quotas were imposed on a discriminatory basis in an effort to prevent deficits as well as for other reasons.

As a result of payments problems most European trade was carried on under a series of bilateral agreements between the various countries and subject to quotas and other restrictions. The extensive government controls limited the total volume of trade and channeled it away from the pattern determined by the efficient allocation of resources, i.e., by comparative advantages and consumers' desires. Payments difficulties became so severe and apparent by 1947 that, since full multilateral convertibility was considered not yet attainable, the European countries endeavored to provide machinery for a clearing of their foreign "soft" currency holdings and for a certain amount of regional convertibility.

In the summer and fall of 1947 plans were developed by the Organization for European Economic Cooperation (OEEC, consisting of the governments participating in the Marshall Plan), for a European clearing organization. Most of the countries had established maximum credits for one another in their bilateral agreements, and any trade in excess of these reciprocal credits had to be paid for in dollars or gold.

According to the multilateral clearing plan originally worked out by the OEEC countries and known as the Agreement for Intra-European Payments and Compensations, which went into operation in January, 1948, there was a monthly offsetting, or compensation, as it was called, of currency holdings in the various clearing accounts. This monthly clearing was voluntary, and was administered bv the Bank for International

Settlements, agent for the arrangement. Some of the countries desired that the clearings be automatic rather than voluntary since this would greatly increase the comprehensiveness of the clearing, but this proposal was opposed by others. The results of the clearing agreement were disappointing, and the volume of clearings small, particularly since countries did not wish to give up holdings of currencies, such as Belgian francs, which were in strong demand, to offset a deficit in a weak currency. The voluntary feature was considered a principal weakness.

Inasmuch as currencies continued inconvertible and the system of import quotas and other restrictions continued to hamper trade and economic recovery, the United States Economic Cooperation Administration sponsored a more far-reaching and authoritative arrangement known as the European Payments Union. This plan contained many of the features which had been proposed for the earlier plan but which had not been accepted. The new plan, the EPU, was finally agreed to by the OEEC countries in September, 1950, after extended technical discussions, and went into effect retroactively, applying to transactions after July 1, 1950.

Countries which expected to be net creditors on intra-European account had desired that the arrangements provide for substantial payments in gold or dollars for net surpluses. Countries that expected to be net debtors, on the other hand, had favored large credit extensions by surplus countries, with only minimum payments in gold and dollars by debtors. The United Kingdom had been reluctant to participate, except on a basis which provided a special position for sterling, primarily because of fear that the United Kingdom might be called upon to make large settlements in gold or dollars, and also because of misgivings regarding the effect on the sterling area. The United Kingdom, however, encouraged by the improvement in its foreign exchange position, finally agreed to the plan on a basis satisfactory to other members.

The EPU is essentially a pool or joint system of payments wherein currencies can be readily converted one into the other. A member, for example, can pay into the EPU whatever member currencies it receives from its exports, and thereby establish

a credit at the EPU available to buy whatever member currencies it needs to pay for imports. The credit may also be used to cancel out any debt it may have to the EPU resulting from past deficits with other member countries. Debits and credits with the EPU are offset automatically without the specific consent of any country, and settlements are made only with respect to net amounts. Proceeds from the exports to any member country can, via the EPU, thus be used to pay for goods purchased from any other member country.

The EPU has funds of its own which may be used to pay a portion of a net debt which a country may owe. These funds are credits provided by the countries which are net creditors, together with funds provided by the United States. These EPU funds are made available to debtors on a basis whereby the larger the debt the larger is the portion of the debt which must be settled by the debtor in gold. This provision discourages the accumulation of debt. A debtor is thus restrained from running a large deficit by the requirement that the larger the deficit the larger is the amount of gold which must be paid to the EPU in settlement. A creditor on the other hand must finance a large part of its own surplus so is interested in avoiding an excessive surplus.

Each country has a quota determined on the basis of its total intra-European transactions in 1949. A net debt or deficit that does not exceed 20 per cent of the quota need not be paid in gold but may be financed by borrowing from the EPU. Deficits in excess of this amount must be paid partly in gold, the gold proportion increasing as the deficit increases. By the time a debtor has exhausted its borrowing privileges with the EPU it will have made gold payments of 40 per cent of its quota and have borrowed 60 per cent. A creditor, on the other hand, will not receive gold for any surplus or credit that it may have until this surplus exceeds 20 per cent of its quota. With respect to surpluses in excess of such 20 per cent, a creditor will receive payment in gold for half of the surplus until the surplus is equal to the creditor's quota. The EPU does not make provision for surpluses or deficits beyond quotas, so that these must be settled with gold.

All accounts at the EPU are kept in terms of a currency unit containing 1/35 of an ounce of gold (0.88867088 grams) which is the equivalent of the United States dollar. No EPU coins or circulating notes are issued. All currencies deposited with the EPU are converted into this EPU unit, which thereby simplifies transactions.

The EPU it will be noted, permits trade to take place multilaterally among members free from the complications imposed by payments problems within the limits set by the quotas. A country can thus buy or sell in whatever market of other members it finds most attractive, and through the EPU can obtain the currencies needed, or can dispose of currencies not needed. In view of the availability of the currencies of members to other members a country does not need to limit imports from another member country because of a lack of its currency, at least until quotas are approaching exhaustion. The EPU thus makes possible the expansion and liberalization of trade. In order further to liberalize trade and promote economic integration, the countries agreed to the reduction or elimination of quotas and other discriminations, no longer necessary because of the payments union. It was planned that by the first of 1951 quotas would be largely eliminated and that the discriminatory application of quotas would be entirely eliminated. This goal, however, was not reached, to a large extent because of the desires of producers to retain the protection which quotas provide against foreign competition.

The question of the area to be covered by the EPU posed a problem inasmuch as to include sterling would require inclusion of the entire sterling area, which embraced such non-European countries as India, Australia, and South Africa. Since sterling is in general freely convertible within the sterling area, if it were made convertible with respect to EPU currencies, all the currencies of the sterling area countries would thereby become convertible with respect to EPU currencies. This broadening of the EPU was considered a desirable feature, and the inclusion of sterling meant that the EPU became much more than a European arrangement. The EPU thus merges the sterling area, franc area, and Western Europe into a single payments area

Within this broad trading zone goods from the various countries can compete free from payments problems.

The EPU was viewed in some United States quarters as a vast nondollar trading area, which would discriminate against goods from the United States and other dollar convertible countries. Discrimination is, of course, inevitable so long as payments problems result in restrictions on dollar imports. The temporary nature of the EPU, at least in its original form, plans for eventual full convertibility, and the contributions of the EPU to intra-European trade were considered sufficient counterbalance to the discrimination involved. Furthermore, while it would be easier for EPU members to trade with each other than with the United States, this situation already existed, and the United States would not lose any markets. The United States encouraged the plan and regarded it as a steppingstone to full convertibility of EPU currencies. During such interval the EPU, accompanied by trade liberalization measures, would, it was believed, facilitate recovery and an expansion of intra-European trade.

The EPU began operations shortly after the invasion of Korea and was immediately confronted with the effects on international trade of the rearmament program. The EPU was based on the principle that liberalization of trade and the restoration of free markets would not only expand trade but also would promote the most effective utilization and direction of resources. Rearmament, however, required certain controls to divert production from meeting consumption demands to meeting military needs. Import and export controls were necessary in connection with rearmament in order to direct use of scarce materials and to prevent leakages to hostile countries. At the same time maximum utilization of resources for preparedness requires the liberalization of trade and the elimination of barriers which do not contribute to military needs. A large proportion of Europe's trade barriers (as in the case of the United States) cannot be justified on economic or military grounds, but are of a protective nature. The essential functions to be performed by the EPU, it can be seen, thus remained during rearmament. The increased supply of dollars in the hands of EPU members, accompanying

increased United States imports, placed members in a stronger position with respect to the EPU objective of trade liberalization and general convertibility.

The total quotas in the EPU amounted in April, 1951, to $3,950 million. The sterling area and France had become leading creditors whereas Western Germany and the Netherlands were large debtors. Total credits extended to the EPU as of April, 1951, amounted to $619 million, whereas total credits from the EPU amounted to $447 million.

Exchange Rate Policy; Flexible Rates.—The extent to which more frequent and greater exchange rate adjustments after the war would have facilitated reconstruction and the expansion of world trade was a matter of debate. It appeared to many persons that exchange rate adjustments lagged and in most cases were inadequate in extent. It was sometimes argued that devaluation should take place by stages rather than be deferred for one large devaluation. In any event, it seems clear that European and other countries maintained for prolonged periods rates that were unrealistic and that could not reasonably be expected to promote equilibrium without extensive restrictions on imports. The countries therefore found it necessary to limit imports rigidly by exchange and other restrictions.

The problems of the extent and frequency of rate adjustments after the war raise the fundamental question of the limits within which maintenance of a particular fixed rate should or should not be sought. The question is essentially that of the kind of conditions under which rate adjustments become desirable, and whether a fixed rate with only rare adjustments is preferable to frequent, perhaps very frequent, adjustments to meet ever-changing economic conditions. The International Monetary Fund, as discussed in the next chapter, is based on the principle of stabilized rates with relatively infrequent changes.

Exchange fluctuations are the source of obvious difficulties. They bring additional uncertainty into foreign trade and financial transactions, cause price fluctuations of imported commodities, windfall profits or sudden losses to certain groups, and may create disturbances such as unemployment or excessive activity

in particular industries. They also contribute to lack of confidence in economic conditions with harmful effects upon investment. Fluctuating rates provide a livelihood for a group of speculators who spring up whenever fluctuations are permitted and who often manipulate fluctuations. Governments may manipulate rates to affect the terms of trade and to "export unemployment."

Fixed rates, on the other hand, also involve difficulties. A fixed rate may require harmful economic adjustments in order to force trade and other international transactions into positions where they balance at the established rate. Foreign transactions in total must yield a demand and supply of bills which equilibrate at the given rate. The attainment of such a balance at the fixed rate may require the imposition of burdensome restrictions on imports or exports, such as exchange restrictions or discriminatory quotas, which interfere with an expansion of trade, or may necessitate internal price, income, and other adjustments which may perhaps be minor or which may be disturbing and harmful to large masses of people. Maintenance of a fixed rate, for example, in the face of a deficit in the balance of payments may require deflation of incomes, prices, and costs so that imports will be reduced and exports expanded. Such a policy would mean unemployment, and as a practical matter would not long be pursued.

The objections to the former gold standard which were so widespread during the 1930's were in reality largely objections to the rigid rates which the gold standard required and to the consequences of measures to maintain these rates unchanged. Under the gold standard the adjustments needed for the maintenance of the fixed rate tended to be brought about automatically. They were frequently disturbing but were endured since maintenance of the gold par was considered essential at all costs.

Maintenance of a fixed rate may thus be in conflict with domestic policies aimed toward full production, economic stability, and the counteracting of booms and depressions. Full employment policies, however, are likely to involve measures, such as prevention of deflation, which are in the direction of economic

stability and which would, in most instances be in harmony with a fixed exchange rate policy. If full employment requires progressive inflation, this coincidence of interest might not prevail. In the event that other countries did not pursue or succeed in policies of economic stabilization, the successful country might find itself out of step with the others and its exchange rate no longer an equilibrium rate. A depression, however, in a major country usually affects trade of other countries, and may lead to pressure on a large number of exchange rates. A depression does not affect all countries or transactions equally so that foreign trade and payments are disrupted and exchange maladjustments occur. The extent to which countries pursue successfully policies of general economic stabilization determines to a large extent the degree to which fixed exchange rates can be maintained.

Disturbances in the balance of payments, apart from those due to the disruptions of war, are commonly the result of inflation or deflation, with consequent effects upon prices and monetary incomes. In practically all countries inflation has been a long continuing process. Throughout the entire world the tendency over the years has been toward continued currency depreciation, sometimes rapid and again slow or temporarily reversed. The fact that all countries follow an inflationary course means that fewer and narrower exchange adjustments are necessary. It is the uneven pace of inflation in different countries that accounts to a large extent for the need for an exchange adjustment. To the extent that countries are able to avoid serious inflation and deflation, or that inflation does not outpace the inflation which prevails in other countries, the prospects for a fixed rate over an extended period are improved. However, inflation, and at an uneven pace compared with that in other countries, is characteristic of practically all countries.

Relative price and cost movements are, of course, not the only influence on the demand and supply of exchange, or in other words on a country's international receipts and payments. Ordinarily, however, the effects of monetary expansion on prices and incomes are the greatest in magnitude of the factors which affect the balance of payments, apart perhaps from the effects

of war, which, however, to a large extent also find expression through inflation. Real changes, such as in productive techniques, which likewise affect the balance of payments, ordinarily take place gradually, and during any given short period of time their effects quantitatively are usually small. Over a period of years, however, real changes may require exchange rate adjustments.

The prospects for the maintenance of a fixed rate of exchange for extended periods, a rate that approximates what would be an equilibrium rate on a relatively unrestricted basis, depend largely (apart from political and other noneconomic influences, which may be extremely strong) on the fiscal and economic policies pursued by the various countries. Similar policies successfully pursued promote stable exchange rates, whereas divergent policies may bring a need for frequent exchange adjustments.

Inasmuch as experience does not provide much basis for expectations that the various countries will effectively pursue policies such as the avoidance of inflation, which promote exchange stability and a fixed pattern of rates, or that political conditions will favor stability, it has been proposed that countries abandon the attempt to maintain fixed rates, and permit a gradual movement of rates up or down in response to underlying forces.[4] Under a system of freely moving rates exchange depreciation keeps pace or anticipates internal depreciation. It has been suggested that countries recognize that a fixed rate between two or more currencies subject to different forces is either not attainable in the face of divergent movements, or to the extent that it is attained is bought at an excessive price. Exchange and other import restrictions or fiscal policies to protect a fixed rate are accompanied by evils which, it is said, in the case of most countries outbalance any gains from the fixed rate.

It has been proposed that governments, therefore, adopt flexible rates and concentrate on the elimination of speculative and other short-term fluctuations through the use of stabilization funds, such as the Exchange Equilization Account of the

[4] Cf. Frank D. Graham, *The Cause and Cure of "Dollar Shortage"* (Princeton, N. J.: Princeton University Press, 1949).

United Kingdom which was utilized so effectively prior to the war in controlling the pound sterling. The business world, it is said, is accustomed to fluctuations in commodity prices, and can similarly adapt itself to movements in exchange rates as has been the case in many countries, especially if these movements are not allowed to be erratic but are in the nature of gradual movements in one direction or the other with perhaps relatively long periods of no or only slight change. Moreover, it is noted that there are constant rumors and little confidence in the permanence of many, perhaps most exchange rates even though the rate may remain stable for a considerable period of time. Rates are not sufficiently secure to give certainty to future transactions, nor are they sufficiently flexible to promote an approximation to free equilibrium.

On the other hand, with adequate reserves and reasonably stable economic conditions, governments should be able to maintain fixed rates for long periods of time without undue difficulties or restrictions on imports, and thereby to obtain the advantages of a fixed rate. The existence of adequate reserves is important in the maintenance of exchange stability. Governments, however, should not be unduly hesitant to make an adjustment in the rate when such is indicated, in view of the adverse effects of a rate which overvalues the currency. Frequent adjustments may be helpful. Reluctance to make needed rate adjustments has too often resulted in disturbing and costly delays and depletion of reserves in the support of an untenable rate.

Flexible rates may, under some conditions, be usefully employed for short periods as a means of ascertaining an appropriate level at which to maintain a new fixed rate. This procedure has been used by Mexico and other countries. During periods of continuing serious instability the advantage may rest with a policy of controlled flexible rates rather than an unrealistic fixed rate. The question of fixed versus flexible rates was debated during the 1930's, as well as in recent years. The International Monetary Fund, whose Articles of Agreement were drafted largely in 1943 and 1944, is based on the objective of fixed rates, although the Fund in some cases has not disap-

proved of floating rates as a temporary device toward a stabilized rate. The problem of fixed rates emphasizes the difficulties which derive from the existence of a large number of independent currencies. Yet an international currency unit appears an impractical goal at the present time in view of the economic and political integration required for its success, and the necessary relinquishment by governments of certain powers which governments have shown an unwillingness to concede.

The need for greater flexibility in exchange rates or more frequent changes in order to minimize maladjustments was stated by Professor Howard S. Ellis as follows:

> What is to be done about exchange rates in the future? Much could be said for the restoration of literally free rates of exchange in the present situation. The structure of exchange rates, despite the 1949 devaluations, is still full of immeasurable maladjustments. Since many items in the balance of payments are inflexible because of government controls, the price of foreign exchange is nearly the sole remaining item which, by its variations, could restore equilibrium in the foreign accounts. Currencies are, however, extremely vulnerable to speculative forces, and it is not without reason that governments would be reluctant to leave them altogether to the vagaries of the day-to-day market. One attractive solution would be the present Italian practice, which uses a "stabilization fund" device, allowing the weekly or monthly drift of the market free play, while controlling the shorter turns. Some such arrangement seems to be required by the necessity of realistic exchange rates on the one hand, and on the other by the impossibility of figuring out a priori a simultaneous solution for all the rates in a situation with an almost infinite number of variables.
>
> If it followed the suggestions advocated here, the I.M.F. would have to accept a far greater degree of exchange flexibility than it has so far been disposed to countenance. In all events it is a question of striking some compromise between strong exchange-rate rigidity (and deviation from "realistic levels") on the one hand, and strong oscillations (and, again, deviations from "realistic levels") on the other. The chaos of postwar exchange rates and the far-reaching structural changes in world trade amply warrant a higher degree of adaptability of rates than was contemplated in the war years when the Fund was planned.
>
> Such a shift in emphasis would involve three procedural changes. It would end the implication that exchange rates are to be set formally

in an international meeting of experts or officials. The foreign exchanges are too much subject to speculation for this procedure; the experts cannot know enough; the subject is too political for objective settlement in this fashion. By and large the market must do the setting. But we have looked favorably toward the stabilization-fund sort of government interference which would mean that any government could control its own rate and thus, if it chose to do so, gradually bring it to a chronically over- or under-valued position. We are thus brought around again to the Fund as an agency to avoid the biases of national authorities.

But there would be the following differences from the originally contemplated procedure: first, as we have said, there would be no officially approved parities and, in the second place, no distaste for rather frequent rate adjustments. The function of the Fund would be to act as a watchdog to guard against rates which are *not* being adjusted toward equilibrium, *i.e.,* cases of undervaluation for the purpose of "exporting unemployment" or of overvaluation for the purpose of concealing the effects of inflation or of securing artificially high terms of trade. Against such abuses the Fund would invoke the same remedies it possesses today.[5]

Gold in International Finance.—Gold has a long history as a monetary metal. In ancient times in Babylonia, Egypt, and China it was used as money in uncoined form. Through the centuries it has been universally desired for hoarding, for ornaments, and, in view of its wide acceptability, for making payments. This situation with respect to gold still prevails. The second World War and the postwar period of uncertainty and depreciation of paper money brought a strong desire in certain parts of the world to hold gold. Gold has thus frequently been selling in black markets at very high prices in terms of United States dollars.

The position of gold in monetary systems has undergone considerable change in the past two or three decades. Under the gold standard as it existed in many countries prior to the first World War, the different forms of money, paper, silver, and the cheaper metals, were freely redeemable in a fixed amount

[5] Howard Ellis. *The Economics of Freedom.*. Published for the Council on Foreign Relations—by Harper & Brothers, N. Y., 1950, pp. 513-514.

of gold. Gold was free to move in and out of countries in settlement of balances, and thereby confined exchange fluctuations within the narrow limits set by the gold points. The inflow and outflow of gold, moreover, affected prices, interest rates, and incomes, and induced adjustments, as discussed in earlier chapters, which tended to promote equilibrium between international payments and receipts. These adjustments were more or less automatic under the former gold standard, inasmuch as central banks' credit policies were made to conform to the state of the gold reserve and the direction of the gold flow.

The meaning of the gold standard underwent a change after the first World War. Credit policies were thereafter largely divorced from the gold reserve and gold flow, so that the so-called price-specie-flow mechanism functioned only slightly or not at all. Free redemption of currency in gold tended to be confined only to large amounts. The domestic use of gold, particularly gold coin circulation, was discouraged. The effort was made to use gold insofar as possible only for international settlements and to concentrate it in reserves where it would be available for such settlements and would also inspire confidence. This tendency developed during the 1920's and especially during the 1930's when balance of payments difficulties and exchange shortages forced countries to husband their exchange resources. The change marked the end of the classic gold standard wherein economic conditions in gold standard countries were largely at the mercy of gold movements.

The gold standard during these years came to mean a currency which was in actual fact maintained at a fixed relation with gold or United States dollars. Redemption in gold was not considered necessary so long as the holder of currency could readily buy at a fixed price dollars or other currencies which were in turn redeemable in gold. A fixed parity with gold and convertibility into currencies which were redeemable in gold thus constituted the essence of what was considered the gold standard. It was in fact what had generally been known as the gold exchange standard, although the gold exchange standard, as previously in force in the Philippines, Nicaragua, etc., pro-

vided formal substitutes for the price-specie-flow mechanism through automatic increases or decreases in the volume of currency.

Under the former gold standard a change in the price of gold, i.e., in the gold par, would have meant an expansion of the currency supply and inflation. The increased value of reserves would have permitted easier credit conditions. With credit policy divorced from gold a change in the price of gold became essentially an exchange rate adjustment, and the internal consequences were largely those resulting from such an adjustment. A change in the price of gold also brings about a change in the local currency value of gold reserves, which may or may not be inflationary (in the case of an increase in price) depending upon what the government does with the revaluation profit. The probabilities are that little inflation would be directly attributable to a revaluation of reserves. A change in the price of gold also affects the mining of new gold, a high price stimulating additional production, which is of little if any benefit to anybody other than the gold mining industry. The gold may eventually find its way into the subterranean vaults of Fort Knox.

Gold producing countries have made a strong effort to have the United States and other countries raise the price of gold. The subject has been brought up at annual meetings of the International Monetary Fund and vigorously urged. The United States and practically all of the other members of the Fund have opposed such a move, recognizing that no economic justification for such a disturbing move exists or is likely to exist.

The world supply of monetary gold, outside the Soviet Union, amounted in 1951 to about $36 billion. Of this sum approximately $22 billion was in the United States. Gold production of the world in 1950, excluding the Soviet Union, amounted to about $850 million.

A strong demand for gold for hoarding has existed in recent years as a result of extensive depreciation of currencies, the disturbances of war, and the uncertainties of the future. Gold has thus sold at a premium in many countries. The principal markets for gold at premium prices are in the Middle and Far

East where in most cases the private holding of gold and domestic transactions in gold are legal. In places such as Tangier and Portuguese Macao operations in gold, including import and export, are subject to few restrictions so that extensive gold operations take place, largely in behalf of buyers and sellers in other countries. The International Monetary Fund has made efforts, in which the United States has been especially interested, to discourage premium gold sales inasmuch as these tend to undermine established gold pars and to absorb into private hoards foreign exchange resources otherwise available for current imports. If the United States were to make gold available freely for hoarding and other purposes it is probable that the premiums for gold would promptly disappear. The United States reserves would probably not be seriously impaired, but foreign countries would find some of their needed dollar resources locked up in private hoards.

The monetary function of gold today has been narrowed until it consists almost entirely of settling international accounts. Reserves have psychological value, contributing to confidence, and governments are especially proud of strong gold reserves. The principal usefulness of gold and other foreign exchange reserves, however, and the main reason why governments desire to possess them, is their ability to settle international balances and thereby to facilitate maintenance of the exchange rate. Generous reserves of gold or foreign exchange provide a buffer to take care of balance of payments deficits during lean periods, and permit the pursuance of a fixed exchange rate policy for extended periods. They also tend to make unnecessary the imposition of exchange restrictions and other undesirable controls. On the other hand, they may also make possible the postponement of a needed adjustment in the rate of exchange when fundamental conditions indicate that such adjustment is necessary. While the function of gold has undergone considerable change in recent decades, and gold is no longer a main determining factor of economic conditions, gold continues to play an important role, even though largely a mechanical one, in international finance.

United States Gold Policy.—The United States Government regulates the holding of gold, its transportation, import, export, etc. Persons may acquire gold for use in industry or the professions for legitimate and customary purposes up to thirty-five ounces at any one time without a license. Beyond this amount a license is required. Gold in its natural state, dust, and nuggets, are exempt from control.

The present gold policy of the United States may be considered to be essentially as follows:

1. Maintenance of the price of gold within the United States at the present figure of $35 an ounce.
2. Concentration of monetary gold in the United States in the hands of the government.
3. Willingness of the government to accept lawfully acquired gold without limit in exchange for dollars.
4. Willingness of the government to sell gold freely to foreign governments and central banks when they wish to use the gold to add to currency reserves and to settle international accounts.
5. Willingness of the government to sell gold, under carefully regulated circumstances, to domestic private buyers for what are considered legitimate purposes such as use of the gold in industry and the arts, but excluding hoarding or speculation.
6. Maintenance of the value or purchasing power of gold at as stable a level as feasible.

Chapter 25

THE INTERNATIONAL MONETARY FUND[1]

Economic Background of Plans for Fund.—The years prior to the outbreak of war in 1939 were ones of special disturbance in the field of international trade and finance, and focused attention on the need for international action to deal with the difficulties which hampered world trade. The problems which prevailed during the 1930's influenced the drafting of the International Monetary Fund, so that a brief review of conditions and practices of that period will help in an understanding of the nature and functions of the Fund.

The depression of the 1930's caused a drastic and uneven decline in foreign trade, with resulting major changes in the demand and supply of the different currencies in the world's foreign exchange markets. The unbalanced condition in demand and supply of currencies, in some cases at times chaotic and panicky, could be met by governments in one of three ways; first, by large payments from gold and foreign exchange reserves, if these were adequate, in order to maintain a stable exchange rate; second, by permitting exchange rates to depreciate and fluctuate; or, third, by the imposition of restrictions on the purchase and sale of exchange, thereby enforcing the fixed rate. All three of these procedures were utilized, usually chronologically in the order stated. Reserves were drawn on heavily and as these became depleted, governments were forced either to permit rates to fluctuate or to impose exchange restrictions. They frequently permitted depreciation and fluctuations, and subsequently imposed exchange restrictions.

[1] Some of the material in this chapter is taken from the author's article, "Developing Plans for an International Monetary Fund and a World Bank," *Department of State Bulletin,* Nov. 13, 1950.

Countries with large gold or foreign exchange reserves, such as the United States, and for a while France, were in a strong position, so that the stability of their exchange rates was reasonably assured. This strength bred further strength as capital in countries with weaker currencies sought a haven in the stronger currencies. The flight of capital, or "hot money" as it was called, added to the difficulties. The strong currency countries accepted but did not always welcome such money, which was recognized as volatile and subject to sudden outflow at the first sign of trouble.

These events emphasized the importance of large currency reserves, not so much for internal purposes, which had formerly received major attention, as to enable the country to meet extraordinary demands from abroad and to maintain the stability of its exchange rate during such periods. Reserves were on occasion supplemented by foreign loans and credits (such as those by the Bank of England, the Federal Reserve Bank of New York and other banks), but the granting of these credits could not be counted upon in advance. One of the needs, therefore, was some means of expanding reserves or providing access to additional reserves in periods of stress, especially when the period of stress was considered to be temporary.

The world was recovering from depression and attention was directed particularly to what were considered cyclical fluctuations in economic conditions. Alternations between prosperity and depression were considered characteristic of a free enterprise economy. The disturbances connected with these fluctuations were regarded as largely temporary and to a considerable extent self-correcting. It was believed therefore that the aid which countries needed would ordinarily be for a limited period. Corrective adjustments, either automatic or administered, would presumably soon remedy the situation. (The ideas of that period regarding a stagnant economy had little effect upon the formulation of the Fund Articles of Agreement.) It was realized that, to the extent that the disturbance was not temporary and a fundamental disequilibrium existed, additional reserves to help maintain an exchange rate that was clearly inappropriate and in need of basic adjustment would merely prolong an un-

tenable position, and at considerable cost. Aid, if given at all under such circumstances, should be given cautiously.[2]

When an exchange rate became depreciated and, as was usually the case during the 1930's, was allowed to fluctuate, the effect on other countries was frequently disturbing. An exchange rate by its nature involves other countries, and its movements are thus a matter of international concern. Moreover, countries would, it was charged, sometimes deliberately depreciate their currencies in order to make their exports cheaper and thereby obtain a competitive advantage over other countries, or in order to promote employment at home by stimulating exports. The aim was thus sometimes said to be "to export unemployment."

Much was said about competitive devaluation and its impropriety. The subject, however, was the source of a certain amount of confused thinking since one of the purposes of practically all devaluations is to improve the competitive position of exporters, and thereby aid the balancing of the country's international accounts. Countries were, nevertheless, fearful of what they considered excessive devaluations by other countries. Devaluations were commonly undertaken unilaterally with little or no prior discussion with other countries, and exchange rate movements were often wide and erratic so that exchange conditions in general tended to be disorderly. It was believed that greater exchange rate stability and international cooperation in the monetary and exchange field especially when rate adjustments were needed, would be in the interests of all countries.[3]

In order to avoid depreciation, countries frequently imposed restrictions on the purchase and sale of foreign exchange, as discussed in Chapter 22. The purpose of these restrictions was to maintain exchange stability and at the same time to provide exchange for essential imports through a system of rationing. Exchange restrictions inevitably involve discrimination against the goods of certain countries, whose currencies are relatively

[2] Article V of the Fund's Articles of Agreement is concerned with this problem of emergency resources and access to them, as noted below.

[3] Article IV of the Fund's Articles of Agreement deals with this problem of exchange rate stability and adjustments.

scarce, and in favor of those of other countries. They also can be and frequently were used to protect domestic industry, and for political and other purposes. Because of the imposition and abuse of exchange restrictions it was generally recognized that here was a field in which international action was needed, although complete elimination of the evils was probably too much to expect.[4]

During the 1930's countries developed the practice of enforcing different exchange rates for different types of transactions, perhaps granting a favorable rate to certain essential imports and an unfavorable rate to luxuries. Similarly, exports that the government desired to promote might receive a specially favorable rate. These so-called multiple currency practices (see Chapter 22), like quantitative exchange restrictions, opened the door to discrimination and related evils. Their introduction complicated trade and made more difficult the return to a free exchange system based on a unitary rate. Although a number of countries employed them, multiple rates were generally considered undesirable even for emergency situations.[5]

The 1930's were years when international trade was subjected to various types of new restrictions and barriers in addition to the familiar tariffs. These trade problems were closely related to the financial problems mentioned above. It was recognized that international financial measures, without complementary measures to reduce and simplify trade barriers, would not by themselves suffice to attain the main objectives to which the international financial measures were directed, namely an expansion of world trade. The International Monetary Fund Articles of Agreement did not attempt to deal with this problem of trade restrictions, although the problem was formally recognized at the Bretton Woods Conference when the articles were drafted.

The decline and disruption of trade during the 1930's and the devices adopted by governments to deal with the situation

[4] Articles VII, VIII, and XIV of the Fund's Articles of Agreement deal with the problem of exchange restrictions.

[5] Articles VIII and XIV of the Fund's Articles of Agreement deal with multiple rates.

made clear the importance of a properly functioning international payments mechanism. The balance of payments maladjustments and the ensuing inconvertibility of certain currencies tended to depress still further world production and trade. If goods could not be traded because of payments problems, surpluses piled up or the goods were not produced at all. In the absence of a single international currency unit, which for practical reasons appeared out of the question, there was need for a multilateral system of payments based on convertibility of major currencies at reasonably stable rates. Exporters and investors needed assurance that they could transfer funds into their own currency without undue difficulty. The establishment of financial machinery designed to accomplish these objectives, at least in part, would require considerable intergovernmental cooperation and joint action.

Formulation of Articles of Agreement; Bretton Woods Conference.—The unsatisfactory state of affairs in the field of international trade and finance prior to the second World War caused many persons to give serious thought to the most appropriate means of improving matters. Within the United States Government an interdepartmental group, appointed at the initiative of Secretary of State Hull, held a series of meetings beginning in the spring of 1940 to consider postwar economic and financial problems. While these meetings were being held the Treasury Department's Division of Monetary Research under the leadership of Harry D. White, a member of the group, gave independent study to these same problems, and in December, 1941, produced a memorandum entitled "Proposal for a Stabilization Fund of the United and Associated Nations." This memorandum was subsequently expanded to include plans for a "Bank for Reconstruction and Development" as well as proposals in the field of commercial policy and commodity agreements. These proposals of the Treasury Department were studied and plans for a Fund and Bank developed over the next few years by an interdepartmental committee known as the American Technical Committee.

During this period when the United States was considering international monetary and financial problems, consideration was being given to the same problems in the United Kingdom. In August, 1942, the British Embassy in Washington transmitted to the State and Treasury Departments copies of a plan entitled, "Proposals for an International Clearing Union." The proposal had been prepared by John Maynard Keynes and came to be known as the "Keynes Plan"; the United States proposal was known as the "White Plan." A series of informal discussions took place between British and American technical experts in regard to these proposals.

The two proposals had many similarities but differed in several important respects. Both plans provided for the stabilization of exchange rates as a main objective and specified that changes in rates could take place, apart from changes within certain narrow limits, only with the approval of the proposed international organization. The United States and other countries were especially concerned over competitive exchange depreciation, and believed that countries should be restrained in undertaking rate changes. They did not then anticipate that in the postwar period countries would lean far in the other direction and be reluctant to undertake needed adjustments, and that pressure to make such changes rather than restraints would be needed.

Both plans provided for an international currency unit defined in terms of gold, called "bancor" in the British plan and "unitas" in the United States plan, and a quota to be assigned each member based upon its economic importance. The quota was to determine the member's drawing privileges on the organization's resources as well as the member's voting rights. The plans differed in their provisions regarding the organization's resources and their availability to members. The United States plan provided for a contributory fund, each member providing its share of the resources based on its assigned quota. Members might have access to these resources under prescribed conditions in order to meet temporary deficits in their balances of payments.

The British plan on the other hand was based on the overdraft principle and provided that creditor countries on current international account would accept from their debtors a credit balance on the books of the Clearing Union, the balance being in terms of the new currency unit, the "bancor." The "bancor" was to be transferable and acceptable by all member countries in payment of international obligations. A debtor country could in this manner pay for its imports by a debit balance against it on the books of the organization up to the amount of its quota. In its original form the British proposal had provided almost no limit on the amount of credit to be supplied by the creditor country. This provision was opposed by the United States, a potential creditor, and was eliminated by the British in the revised version of their proposal.

The Keynes Plan also provided that a credit balance which remained unused for a certain period of time was automatically canceled. Thus, if a country continued, on total current account, to export more heavily than it imported, it would accumulate credits which it would lose unless it were to spend them prior to a certain date. The reasoning was that the burden of adjustment to bring international accounts into balance should be placed more heavily on the creditor than it had been in the past. This reasoning visualized the postwar problem as one of inadequate imports by certain countries. Unless such countries imported more goods, the credits earned by their exports would be canceled according to the Keynes Plan. A debtor country could therefore continue to import without embarrassment. The United States did not accept this provision.

In addition to the discussions between British and American representatives as to these plans, discussions were held by the United States with representatives of some twenty other countries. Plans were made for the holding of an international conference to consider and obtain agreement upon a proposal for a monetary institution and perhaps for a bank. The United States and United Kingdom recognized, however, that they must themselves reach agreement on all major points if such a conference were to be successful. Accordingly, a series of meet-

ings took place in Washington between representatives of the two countries, Lord Keynes heading the British group. The British believed that a member of the proposed institution should have the right to draw on the institution automatically up to the amount of the country's quota. The United States on the other hand believed that the institution should exercise control over all drawings to see that the resources were utilized for the purposes intended, namely to enable a country to meet a temporary strain or to have time to make appropriate adjustments in its economy.

Other matters at issue concerned rights of a country to alter unilaterally its exchange rate, the amount of the quota payable in gold, repayment of borrowings from the Fund, etc. The United Kingdom and other countries were fearful of a depression and mass unemployment in the United States, and felt that in linking their currencies to gold and the dollar they would be unable to resist the spread of depression, and would be "tying themselves to the tail of the United States kite." They therefore desired flexible provisions regarding the alteration of exchange rates. The drafting of the Fund provisions was influenced by a belief that deflation would be a major postwar problem, a reflection of the depression difficulties of the 1930's and of the teachings of Keynes.

Agreement between the United States, the United Kingdom, and a few other major countries was finally reached in April, 1944, on what was called a "Joint Statement by Experts on the Establishment of an International Monetary Fund." This statement contained the outline of the plan fully worked out later at Bretton Woods.

President Roosevelt issued invitations to forty-four nations to send representatives to a conference to be held in July, 1944, at Bretton Woods, New Hampshire, to consider the plan on the basis of the Joint Statement. A preliminary meeting of representatives of seventeen countries met a few weeks in advance at Atlantic City to deal with some of the still unsettled questions. At the Bretton Woods conference the countries exhibited a special interest in obtaining as large a quota as possible since the quota determined rights to borrow and also voting

power. The size of the quota came to be regarded also as a measure of a country's economic importance and was therefore a matter of national prestige.

After two weeks of intensive work differences of opinion were resolved and the conference produced the Articles of Agreement of the International Monetary Fund, which were to constitute the basic charter for the Fund. The Articles required formal approval by legislative bodies before they could become effective. The United States Congress gave its approval and authorized United States participation in the Fund (and also in the Bank) in July, 1945. On December 27, 1945, the Articles were signed by 30 countries, joined later by others, and the Fund thereby came into formal existence. The International Bank, discussed below, was developed alongside of the Fund and its Articles of Agreement were signed at the same time.

Nature of Fund.—The nature of the Fund is reflected in the statement of its purposes as set forth in Article I of the Articles of Agreement. These purposes include the following:

(3) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(4) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(5) To give confidence to members by making the Fund's resources available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

The principal provisions in the Articles of Agreement through which realization of the above objectives are sought may be summarized as follows:

1. Member countries undertake to keep their exchange rates as stable as possible, confining fluctuations within narrow limits,

which are specified, and to make no change in rates unless the change is essential to correct a fundamental disequilibrium.

2. Any adjustment of an exchange rate must in all cases be made by consultation with the Fund. Beyond certain small changes (10 per cent of initial par value) rates can be adjusted only with the concurrence of the Fund.

3. Par values of the currencies of members are stated in terms of gold (or United States dollars of the weight and fineness as of July 1, 1944); gold is accepted by members in settlement of accounts.

4. The Fund possesses financial resources which are contributed by the members on the basis of their assigned quotas. These resources are available under safeguarding conditions to help members meet temporary shortages of exchange.

To draw on the Fund's resources a member exchanges its own currency for the desired foreign currency. The resources of the Fund are intended to assist a member in financing temporary deficits in its current international accounts, and thereby to aid it in maintaining foreign exchange stability until such member has had time to correct maladjustments. For example, a member country may find its agricultural exports reduced because of a crop failure, and accordingly not have adequate foreign exchange resources with which to pay for its imports. The Fund may then allow such member to buy from the Fund certain amounts of foreign currency. The Fund thus might exchange dollars, pounds, or francs for additional amounts of such member's own currency.

The resources of the Fund are not intended to be used to provide capital for investment or other long-term purposes, but are available to members only to aid them in making payments for current transactions, which are defined in the Articles of Agreement. The resources are to provide for fluctuations in current or noncapital items in the balance of payments. If the Fund were to permit its resources to be used for capital purposes or to meet chronic deficits, its gold, United States dollars, and other specially desired currencies would soon be drawn out and its resources would consist of currencies not desired by others. The Fund therefore scrutinizes applications to draw on the

Fund to see if they conform to the requirements in the Articles of Agreement and the Fund's regulations. A member's rights to draw on the Fund's resources are related to the size of its quota. Except in unusual circumstances a member may not draw in any one year more than 25 per cent of its quota, nor may the Fund hold the currency of a member in excess of 200 per cent of such member's quota.

The Fund makes a charge on money drawn. The charge increases progressively with the amount of the total outstanding drawings by a member and with the length of time these drawings are outstanding. The charges provide the Fund with money for its operating expenses.

5. One of the main objectives of the Fund is the elimination of restrictions on exchange transactions and the restoration of a relatively free multilateral system of payments wherein currencies are readily convertible one for the other. Accordingly, member countries agree not to engage in discriminatory or multiple currency practices or similar devices or to impose restrictions upon payments for current international transactions, except as authorized by the Agreement or approved by the Fund. Previously existing exchange restrictions and practices are permitted during the postwar transitional period (under Article XIV), but are to be abandoned as soon as conditions permit. Restrictions on capital transfers are permitted. If the demand for a particular currency threatens the ability of the Fund to supply that currency (i.e., a scarcity of the Fund's holdings of a currency) the Fund may formally declare such currency scarce. In this event members may temporarily impose restrictions on transactions in the scarce currency.

6. Member countries agree to protect the Fund against depreciation of their currencies which the Fund holds; they thus agree to maintain the gold value of their currency held by the Fund, by supplying an additional amount if necessary, so that the total assets of the Fund will not depreciate in terms of gold.

7. The Fund may deal only with governments or their agencies and may have no direct contact with the foreign exchange market.

8. The Fund is governed by a Board of fourteen Executive Directors (there must be at least twelve), which functions in continuous session at the Fund's headquarters. Five of these are appointed by the countries with the five largest quotas, namely the United States, the United Kingdom, China, France, and India, and the remainder are elected by the other members. The Board of Governors, which has final authority, consists of one governor and one alternate appointed by each member and meets annually. Voting of members in both Boards is weighted according to the size of a member's quota. There were 49 members as of July, 1951, Poland having withdrawn.

The Fund in Operation.—The Articles of Agreement were signed in December, 1945, and the Fund got under way in the spring of 1946. One of the first major tasks of the Fund was to determine whether to accept as par values the rates of exchange of the members which were then current and were communicated to the Fund for acceptance late in 1946. Those rates were in many cases clearly inappropriate as permanent rates. International trade was disturbed by the war which had recently ended, and under the prevailing conditions nations were not inclined to adjust exchange rates even though the existing rates were recognized as unrealistic. It appeared to many persons, nevertheless, that some adjustment of rates would aid recovery. Devaluation was politically unpopular and in some cases was said to be infeasible in that it would probably produce a political upheaval and threaten the introduction of a communist government. The problem before the Fund was not easy. The Fund was still young and its authority untested. It took the course of accepting without question all the par values filed with it—although it recognized that subsequent adjustment was needed.

Since the initial acceptance by the Fund in December, 1946, of the par values filed with it, a large number of rate adjustments have been made. Member governments, with a few exceptions, have observed their obligations to consult with the Fund before adjusting their rates, and to obtain the Fund's approval if the change were more than the specified amount not

requiring approval. The major devaluations in September, 1949, put the Fund's machinery to the test. At that time, when the pound sterling and many other currencies were devalued the Fund was in every instance consulted and worked closely with the members. The decision in each case was essentially that of the member, and the Fund's role was largely one of concurrence. Nevertheless the devaluations, announced more or less simultaneously, were more orderly than if there had been no Fund. The Fund's influence was felt more during the period which preceded the devaluations, than at the time of devaluation and the selection of a rate. In the case of new members, the Fund has on occasion not accepted a par value which appeared inappropriate. Discussions with members have taken place and a par finally agreed upon.

Use of Fund's Resources.—The question which has been the subject of the greatest controversy within the Fund has been that of the utilization of the Fund's resources. Differences of opinion have existed regarding the standards to be applied when a member desires access to the Fund's resources, and regarding the extent to which the resources should be utilized during the postwar years of special disturbances, many of which did not appear to be of a temporary kind visualized in the Articles of Agreement. One group has urged that standards be liberal and that rights to draw be regarded as available for use largely on an automatic basis. It is thus argued that a member should be able to consider its drawing rights as part of its currency reserve, and therefore should know that it can count on being able to draw without question. Certain minimum standards, it is said, could be set to protect the Fund against abuse, but that the resources should in general be available to a member as the member may determine its requirements, within the limits established by the Articles of Agreement. The Fund need exercise, it is said, little discretion with respect to individual drawings.

The other group, principally the United States, has believed that the resources should be used cautiously in a period of widespread and sustained balance of payments disequilibrium, in

order that the resources may not be dissipated and the Fund be unable to continue effective operations. Consistent with such a policy each application to draw, it is held, should be scrutinized carefully to see that it conforms to the standards established in the Articles of Agreement. According to original plans as formulated at Bretton Woods, the resources were intended to be available only to help meet temporary maladjustments until remedial measures could be taken to restore equilibrium, or until a balance would eventuate automatically. The United States thus desired a discretionary Fund and reasonable conformance to the principle of aiding temporary rather than fundamental and continuing maladjustments.

When the Articles of Agreement were drafted it was not contemplated that the member countries would have continued large deficits in their balance of payments on the scale that existed after the war. It was assumed that measures would be taken to restore a balance with reasonable promptness, and that the aid needed would be to meet a temporary emergency situation. A chronic or fundamental disequilibrium was expected to be met by appropriate adjustments such as devaluation rather than through use of the Fund's resources. Curtailment of imports through exchange restrictions and other devices was also not considered the appropriate method of meeting a deficit, except perhaps until corrective measures could be taken. The postwar period, however, saw countries with large deficits year after year, and import controls substituted for fundamental remedies.

Exports and imports were to a large extent regulated or planned by governments, so that deficits were to a considerable extent the result of programs based on government decisions. Under such conditions Fund resources, if made readily available to members, would continue to be drawn on until they (i.e., the specially desired resources, gold, and dollars) were exhausted. The situation which actually eventuated was not visualized, at least in its extensiveness, when the Articles were drafted. Balance of payment deficits were not of an emergency short-term nature likely to be offset eventually by surpluses,

but were in many cases accepted or chosen deliberately in place of the remedies necessary for a balance. Countries attached more importance to their import programs than to balanced accounts, so long as the deficit could in some manner be financed. When the deficit became bothersome, import controls were tightened, which was politically easier than devaluation or the checking of inflation. Political conditions were in some instances unstable so that the government as a practical matter had little choice but to delay fundamental adjustments.

Thus a major problem before the Fund has been how it should operate in the kind of world in which it found itself and which was different from that anticipated when the Articles of Agreement were drawn up. Under the conditions which have prevailed the Fund has had the choice of being largely inactive, insofar as the use of its resources was concerned, or of finding some means of adapting itself to the altered situation, that is, of developing standards which would protect its position but at the same time permit it to render at least some financial assistance to members. It has been proposed, for example, that its loans have a definite and short-term maturity and be made available to countries that appeared able to repay.

The Fund has made its resources available to members only to a limited extent. Drawings have been permitted in certain cases where the member has had a special need and appeared to be taking constructive measures, or was prepared to take such measures, to reduce the deficit, even though equilibrium was not in sight. These measures have frequently been little more than restrictions on imports. The Fund has been tolerant, on the basis of a strict interpretation of the Articles of Agreement, in extending financial aid to members, but even so the drawings permitted have been relatively small and some members have been dissatisfied. At the outset of the ERP program the United States requested that the Fund not permit drawings by ERP countries except in unusual circumstances, since the United States was providing for their deficits. The Fund conformed to this policy. As of June, 1951, the net amount of the Fund's dollars made available to its members was $733 million.

Drawings in other currencies were relatively minor. Its total resources amounted then to the equivalent of a little over eight billion dollars.

In order to increase the usefulness of the Fund and to find a means of utilizing appropriately its idle resources, the Fund has given much attention to the question of the use of its resources under prevailing conditions. It has not as yet, however, succeeded in finding a solution satisfactory to all members.

The Fund and Exchange Restrictions.—One of the principal objectives of the Fund according to the Articles of Agreement is, as noted above, "the elimination of foreign exchange restrictions which hamper the growth of world trade" and the restoration of multilateral convertibility of currencies. The Fund, however, in its day-by-day operations and in its relations with members has found it difficult to implement this objective. Officials in a number of countries have been inclined to view exchange restrictions as the logical means of remedying a deficit in the balance of payments. Exchange controls are often viewed as a more or less permanent device and countries resist their relaxation.

Beginning in 1950 the Fund issues annually a detailed report on exchange restrictions still in force under the provision (Article XIV) which permits restrictions during the so-called transitional period. These reports are required by the Articles of Agreement. The 1950 report noted that little progress had been made in the elimination of such restrictions. The second report, issued in May, 1951, also indicated dissatisfaction with the rate of progress and said that in view of the general improvement in balance of payments conditions substantial relaxation or removal of restrictions was feasible for a number of countries. The report said:

> The same factors tending toward the elimination of the so-called "dollar shortage" have worked toward the disappearance of the distinction between "hard" and "soft" currencies and of the distinction among various "soft" currencies. The Sterling Area, in particular, has greatly bettered its position vis-a-vis many countries whose currencies were previously relatively "hard." Sterling has emerged as a much "harder" currency. The previous tremendous gulf between "hard" and

"soft" currencies, which has been a very substantial obstacle to the restoration of convertibility, seemed to be narrowing markedly at the end of 1950. . . .

The extent of the improvement has made financially possible a considerable relaxation of restrictions and an approach toward convertibility. The nature and magnitude of the action which has become financially possible varies among different countries. For some, the new situation means that restrictions could be eliminated. . . .

Especially the marked improvement of the gold and dollar position of countries would seem to remove the basis of most currency discrimination on current transactions which continues to be practised to a considerable degree.

Thus, for many countries, the balance of payments reasons for restrictions on current transactions have been greatly reduced, if not eliminated. Recognition must, however, be given to the uncertainties of the present situation and to the impediments to the removal or relaxation of restrictions. . . .

In addition to the uncertainties affecting the future balance of payments and reserve positions of a number of countries, there are certain other, largely non-financial, impediments to achieving the purposes of the Fund. Important among such impediments is the *protectionist* aspect of restrictions which build up vested interests in protection from outside competition, interests which may seek to prevent the removal of restrictions even although they are no longer necessary for financial reasons. In addition, as relaxation of restrictions takes place, there is considerable likelihood that priority in relaxation will be given to imports of those commodities for which domestic substitutes are not available. In this way, the restrictions which remain may well be the ones with the greater protectionist elements. The removal of such restrictions protecting uneconomic industries may thus prove increasingly difficult, despite the improvement in a country's financial position. Moreover, an inertia favorable to the maintenance of restriction tends to be created after they have been in force for some time. . . .

. . . restrictions may be maintained as *bargaining weapons* to secure concessions from other countries in bilateral negotiations. . . .

In conclusion, despite the existing uncertainties and difficulties, the Fund believes that many countries are in a position to undertake substantial removal of discrimination and relaxation of non-discriminatory restrictions, and to make significant progress toward convertibility.[6]

[6] International Monetary Fund Second Annual Report on Exchange Restrictions, April, 1951.

TABLE 10. INTERNATIONAL MONETARY FUND

Members' Quotas, Par Values and Fund Holdings of Member Currencies as of the End of March, 1951

(A number of countries have not yet established par values)

Member	Member's Currency	Quota	Subscription			Fund Operations in Member Currencies; Net Fund Purchases or Sales (—)	Fund Holdings of Member Currencies		Par Values
			Paid in Gold‡	Paid in Member Currency					
		(Millions of U. S. dollars)	(Millions of U. S. dollars)	(Millions of U. S. dollars)	(Per Cent of member's quota)	(Millions of U. S. dollars)	(Millions of U. S. dollars)	(Per Cent of member's quota)	(U. S. Cents per Currency Unit)
Australia	Pounds	200	8.40	191.60	96	20.00	211.58	106	224.
Austria†	Schillings	50	—	—	—	—	—	—	—
Belgium	Francs	225	56.25	168.75	75	.01	168.75	75	2.
Bolivia†	Bolivianos	10	—	—	—	—	—	—	1.667
Brazil	Cruzeiros	150	37.50	112.50	75	65.50	178.00	120	5.405
Canada	Dollars	300	75.00	225.00	75	—	224.99	75	—
Ceylon†	Rupees	15	.75	—	—	—	—	—	—
Chile	Pesos	50	8.82	41.18	82	8.80	49.98	99.9	3.226
China†	Yuan	550	.06	—	—	—	—	—	—
Colombia	Pesos	50	12.50	37.50	75	—	37.50	75	51.283
Costa Rica	Colones	5	.37	4.63	93	—.87	3.75	75	17.809
Cuba	Pesos	50	12.50	37.50	75	—	37.49	75	100.
Czechoslovakia	Korunas	125	2.37	122.63	98	6.00	128.67	103	2.
Denmark	Kroner	68	5.94	62.06	91	10.20	72.30	106	14.478
Dominican Republic	Pesos	5	1.25	3.75	75	—	3.75	75	100.
Ecuador	Sucres	5	1.25	3.75	75	—	3.75	75	6.667
Egypt	Pounds	60	9.49	50.51	84	—5.51	45.00	75	287.16
El Salvador	Colones	2.5	.63	1.87	75	—	1.87	75	40.
Ethiopia	E. Dollars	6	.06	5.94	99	—	5.94	104	40.25

Finland†	Markkas	38	—	—	—	—	—	—	—
France	Francs	525	108.11	416.89	79	125.00	541.78	103	—
Greece†	Drachmas	40	—	—	—	—	—	—	—
Guatemala	Quetzales	5	1.25	3.75	75	—	3.75	75	100.
Honduras	Lempiras	.5	.13	.37	75	—	.37	75	50.
Iceland	Krónur	1	.25	.75	75	—	.75	75	6.14
India	Rupees	400	27.53	372.47	93	99.98	472.43	118	21.
Iran	Rials	35	8.77	26.23	75	—	26.23	75	3.1
Iraq	Dinars	8	—	8.00	100	—	8.00	100	280.
Italy†	Lire	180	.02	—	—	—	—	—	—
Lebanon	Pounds	4.5	.27	4.23	94	—	4.23	94	45.63
Luxembourg	Francs	10	.48	9.52	95	—	9.52	95	2.
Mexico	Pesos	90	22.50	67.50	75	22.50	90.00	100	11.56
Netherlands	Guilders	275	68.75	206.25	75	75.39	281.63	102	26.316
Nicaragua	Córdobas	2	.50	1.50	75	—	1.50	75	20.
Norway	Kroner	50	12.50	37.50	75	9.56	47.06	94	14.
Pakistan†	Rupees	100	3.50	—	—	—	—	—	30.225
Panama	Balboas	.5	.13	.37	75	—	.37	75	100.
Paraguay¶	Guaranies	3.5	.88	2.62	75	—	2.62	75	16.667
Peru	Soles	25	3.15	21.85	87	—	21.85	87	—
Philippines	Pesos	15	3.75	11.25	75	—	11.25	75	50.
Syria	Pounds	6.5	.17	6.33	97	—	6.33	97	45.631
Thailand†	Baht	12.5	3.13	—	—	—	—	—	—
Turkey	Liras	43	10.75	32.25	75	5.00	37.25	87	35.714
Union of South Africa	Pounds	100	25.00	75.00	75	.01	75.00	85	280.
United Kingdom	Pounds	1,300	236.27	1,063.73	82	265.96	1,331.30	102	280.
United States	Dollars	2,750	687.50	2,062.50	75	—732.99	1,313.71	47	100.
Uruguay†	Pesos	15	—	—	—	—	—	—	—
Venezuela	Bolivares	15	3.75	11.25	75	—	11.25	75	29.851
Yugoslavia	Dinars	60	7.88	52.12	87	9.00	61.17	102	2.
Total		8,036.5	1,470.05	5,563.41		—16.47‖	5,532.65		

† As of March 31, 1951, the situation in regard to these members, payments of whose subscription had either not been received or not been completed, was as follows: Bolivia, one of the outstanding legal points having been cleared, the Fund is awaiting action by the member to effect payment of the subscription. In other cases currency subscriptions were not yet due.

‡Gold payments of Lebanon, Syria, and Yugoslavia are in accordance with a provisional determination and are subject to adjustment.

§ Provisional.

‖ Represents net Fund purchases of gold.

¶ Following the change in the par value of the guarani on March 3, 1951, Paraguay must pay an adjustment in guaranies to maintain the gold value of the Fund's holdings of its currency. In the meantime, the U. S. dollar equivalents and percentages of member's quota are calculated to include this payment.

Source: International Financial Statistics. International Monetary Fund, Washington, D. C.

The report also reminded Fund Members that "Article XIV of the Fund Agreement provides that five years after the date on which the Fund begins operations (March 1952), and in each year thereafter, any member still retaining any restrictions inconsistent with Article VIII, Sections 2, 3, or 4, shall consult the Fund as to their further retention. In anticipation of these consultations, the Fund intends to be in contact with its individual member countries on the implementation of these provisions." [7]

The Fund has also had to contend with difficulties in regard to exchange rate adjustments, especially the reluctance of governments to deal with the question realistically. Devaluation is usually politically unpopular and for this and other reasons is a delicate issue. If a country is to balance its international accounts without exchange or other import restrictions, and is to establish currency convertibility, devaluation may be essential. The Fund has had to contend with the reasoning, popular after the war, that exports and imports are relatively inelastic and that an exchange rate adjustment cannot readily, or without serious disturbance, promote a balance in international accounts. While such a situation may exist, cases in which this reasoning is applicable are probably not very numerous.[8] The Directors of the Fund have represented governments with varying degrees of belief in the advantages of the free enterprise system and liberal multilateral trade. Differences of opinion have thus arisen. The Fund is still a young institution which has had to acquire strength and prestige, but it is making progress under difficult circumstances.

Other Fund Activities.—The extension of financial aid is not the only means by which the Fund assists its members. One of the significant contributions of the Fund has been the technical advice which it has extended in the monetary field. It has assembled in Washington a staff of financial experts from many countries who are made available to members for special assignments upon request. The Fund has missions constantly in the

[7] *Ibid.*

[8] The questions of exchange rate stability, frequent adjustments and flexible rates are discussed in Chapter 24.

field studying local conditions and conferring with members on their problems. It has advised with members on measures to check inflation, to simplify their exchange structure, and to pursue policies conducive to financial stability and the elimination of restrictions.

The Fund also makes extensive financial studies at its headquarters in Washington. Most of these studies are for internal purposes, but the Fund issues several valuable publications. Its regular monthly bulletin, *International Financial Statistics,* is comprehensive and fills an important need.

The Fund maintains its main offices in Washington and in 1951 had a total staff of some 450 persons from about thirty different countries. Its operating expenses were approximately five million dollars per year and its income about four million dollars per year. Its total resources as of June, 1951, were the equivalent of \$8.037 billion, of which \$1.495 billion consisted of gold and \$1.313 billion of United States dollars.

The accompanying Table 10 shows the Fund members, their quotas and other Fund data.

It is not possible to discuss here all the problems that have confronted the Fund such as the interpretation and application of the special provisions (Article XIV), which permit a member to retain exchange restrictions during the postwar transitional period, gold policy and efforts to prevent the sale of gold at premium prices, relations of the Fund with the European Payments Union and the effect of the rearmament program upon the Fund. The Fund, like any institution, has been subject to criticism, but is performing a useful function and bringing about a substantial amount of international cooperation in the field of currency and exchange.

Chapter 26

SILVER IN INTERNATIONAL FINANCE

Silver in Currency Systems.[1]—At the present time no country has the silver standard, although a number of countries have silver coins in circulation.[2] When China left silver in 1935 there came to an end a period of many centuries, during which silver had served as a monetary standard and measure of values in some part of the world. The silver standard has served practically every country at some time or other. Until the large gold discoveries of modern times silver was the principal currency of the world and was found in the market places of all countries. Gold was too valuable for most of the ordinary transactions, although it is said that in the early days in China silver was more valuable than gold due to the small amount of silver production in the Orient.

Bimetallism, the joint use of gold and silver, prevailed extensively for many years, but for the past approximately 100 years gold has held sway alone throughout most of the civilized world. While gold is still used in monetary systems, the gold standard in its historic sense is now a thing of the past. Silver continued for a long time in certain areas, but has finally disappeared as a currency standard, and is rapidly declining as a currency metal.

Silver is today merely a commodity, in the same sense that copper, nickel, or iron are commodities. The fact that silver continues to be used as the material for coins does not mean

[1] A discussion of exchange rates on silver-standard countries is contained in Chapter 5 on foreign exchange.

[2] Saudi Arabia has an approximation to the silver standard in that the coins circulate on the basis of their bullion value. However free coinage does not exist, and coins are minted only for government account. The exportation of silver is forbidden.

the silver standard. The value of silver coins in all countries (except perhaps Saudi Arabia) is now divorced from the value of the silver in the coins, so that the coins can just as well be made of inferior metal, as governments now understand. Free coinage of silver no longer exists anywhere, so that in no country is it possible to obtain a fixed amount of money for silver bullion.[3] Conversely, the monetary value of silver coins is greater than the value of the silver they contain, so that a person would be foolish to melt down coins to obtain silver. Silver can be bought as bullion much more cheaply than obtained from coins. According to the present price of silver (about ninety cents an ounce), the American silver dollar contains about seventy cents worth of silver. Originally, when this country had bimetallism and when the price of silver was higher, in terms of gold money, the silver in the American silver dollar was worth one dollar.

Although United States silver coins are merely token money, their value would be affected by their silver content if the price of silver should rise to over \$1.29+ per fine ounce. The commodity value of the silver in the coins would then exceed their monetary value, and lead to their being melted down. In the case of a country whose currency consists almost entirely of silver money, a rise in the price of silver might place such a country upon a de facto silver standard. Most countries have experienced troubles of this kind at some period in their history. In 1920 the price of silver rose so high that the American silver dollar contained a little more than one dollar's worth of silver. Some of the silver dollars were then shipped to the Orient where they were melted down. The price of silver soon declined so that this procedure was no longer profitable. Silver dollars are such a minor factor in the United States currency system that had they all been exported, this country would not have been materially affected.

Mexico where silver pesos and smaller coins of silver are widely used, has had experiences of this nature which were more serious. For example, in 1935, under the stimulus of the Amer-

[3] The United States Government, however, buys domestically mined silver at a fixed price.

ican silver-buying program, silver rose in price to a point where the peso contained more silver than its face value. Pesos accordingly began to be withdrawn from circulation, hoarded, melted down, or exported to the United States. Credit contracted and Mexico experienced a financial crisis. The Mexican Government thereupon closed the banks, called in all the silver pesos, and substituted for them paper and bronze coins. Subsequently, coins of a lower fineness were issued.[4]

Production and Price of Silver.—The largest silver-producing country is Mexico, long famous for its rich silver mines. Mexico is followed by the United States and Canada. Before the second World War the world's silver production amounted to about 260 million fine ounces annually. Mexico accounted for about 75 million ounces of this amount and the United States for about 60 million ounces. Since the war, silver production has been less, world output amounting in 1950 to about 157,000,000 ounces. Mexican production in 1950 was about 47,000,000 ounces and that of the United States about 42,000,000 ounces. The accompanying chart shows the world production of silver since 1915. Silver is produced today largely in conjunction with other metals, namely, copper, lead, and zinc, so that the production of these metals adds to the production of silver.

The monetary use of silver has been declining for several decades. India, prior to 1893, a silver-standard country, was for centuries a substantial user of the metal. Huge quantities of silver, and also gold, found their way to India, and stayed there. During the latter part of the 1920's and the first part of the 1930's, however, India became a large exporter of silver; but as a result of the war, again absorbed silver. Because a large part of its currency consists of silver rupees, India has often been mistakenly referred to as a silver-standard country.

[4] Mexico is sometimes mistakenly said to be on the silver standard, particularly in the light of the law of July 25, 1931, which declared the silver peso the monetary unit. This law, however, did not introduce the silver standard. It did not provide for the free coinage of silver, and the value of the peso has been independent of the price of silver. The peso has been relatively stable with reference to gold most of the time since early 1933 and is fixed at 8.65 pesos to the United States dollar.

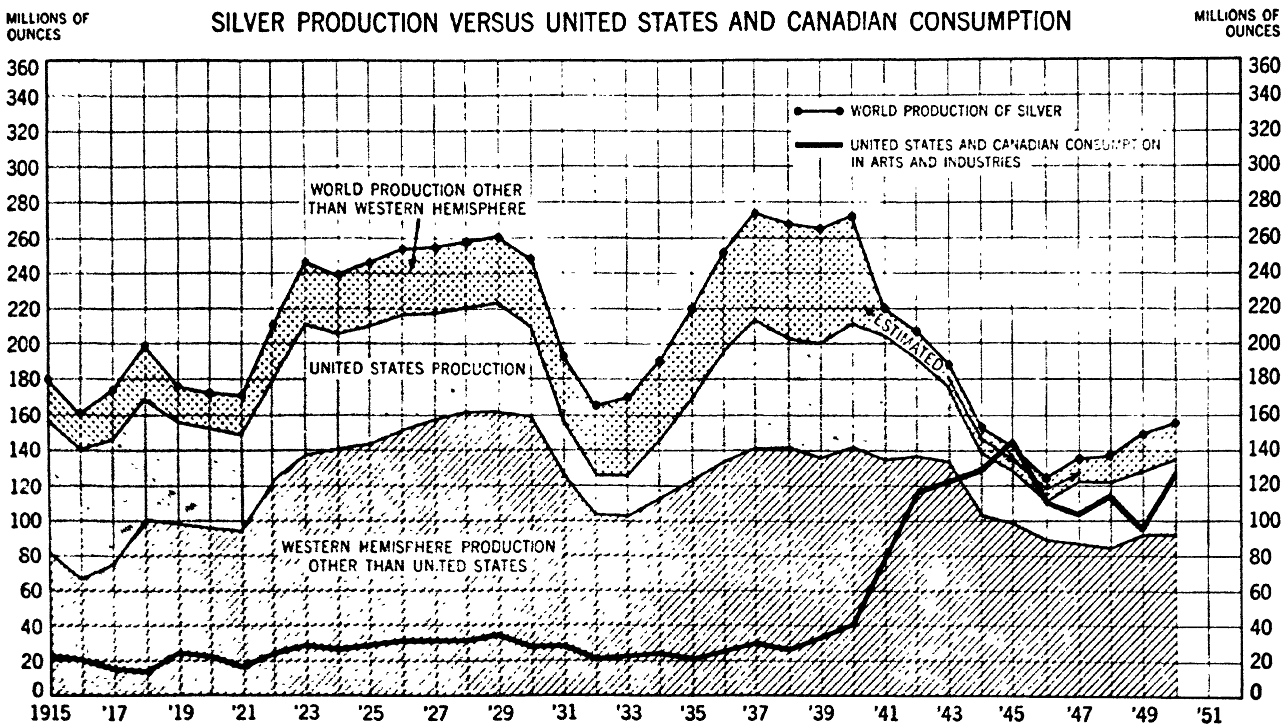

FIG. 5.—World Production of Silver and United States and Canadian Consumption in Arts and Industries

(Source: Handy and Harmon, New York.)

The rupee since 1893 has been a fiduciary coin, like American silver coins. Its value is tied to the pound sterling and not to silver. India has put into circulation a large number of rupees which contain no silver. After 1927 the Indian government endeavored to sell on the world market a substantial portion of its large and unneeded silver reserve. China, also a major user of silver for centuries, similarly became an exporter of the metal, as noted below.

Apart from the gradual abandonment of the silver standard, the use of silver as the material for coins has also declined. Following the first World War, paper money came to be used for smaller denominations than formerly, thus narrowing the field for silver. Furthermore, there was a tendency to use cheaper metals for subsidiary money in place of silver, and to have a lower fineness of silver in coins. The second World War increased the trend away from silver for coins.

The consumption of silver by industry and the arts prior to 1940 was not large. In 1937 about 17 per cent of new production went into industry and the arts.[5] During the war, however, and the accompanying scarcity of all metals, the demand for silver greatly increased. Silver was used as a substitute for copper since it is a good conductor of electricity. It is used extensively in the production of aircraft, ordnance, and naval vessels. After the war the industrial demand for silver continued large, especially for use in silverware. Silver is also used in photography, the electrical industry, and for brazing alloys. About two-thirds of the current world production of silver has come to be used by industry and the arts, and the amount is increasing.

In view of the long-term downward trend in the demand for silver, accompanying the world-wide abandonment of the silver standard, the price of the metal, in terms of gold, was declining for many years. In 1931, during the depression of that period, the price of silver descended to the lowest point reached in 2,000 years. The price of silver began to decline about 1873,

[5] Cf. Handy and Harman, *Annual Review of the Silver Market.*

and gradually fell lower and lower, reaching its lowest level at the first of 1933.[6] Early in 1933 the United States Government took an interest in silver, and the price rose sharply. In response to government purchases, the world price rose from about twenty-five cents an ounce at the first of 1933 to eighty-one cents in May, 1935. It was then allowed to decline to about forty-four or forty-five cents early in 1936. During the war the price was around forty-five cents, but after the war it rose sharply and in the spring of 1951 was about ninety cents an ounce. The price of newly mined domestic United States silver has been pegged, as noted below.

The price of silver, in terms of gold, was extremely unstable during the two decades prior to the war, gyrations in price being equaled by those of few other commodities. In spite of this instability, some nations, notably China, attempted to use silver as a currency standard, but were forced to abandon it.

Silver in American History, 1792-1929.—The question of silver in the United States, from the economic point of view, would be of no great significance were it not for the political interest in the question and the resulting governmental measures.

The antecedents of the so-called "silver question" in the United States may be traced to 1792, when the United States adopted the bimetallic standard. According to the Act of 1792 both gold and silver could be taken to the mint for coining in unlimited quantities. The ratio between the two metals was fixed at 15 to 1; that is, the mint would accept for coinage fifteen ounces of silver as the equivalent of one ounce of gold. Coins were minted and paid out on this basis. The market ratio between the metals, however, was soon out of harmony with this mint ratio. In the market one ounce of gold would buy a little more than fifteen ounces of silver. The result was that the dearer metal, gold, disappeared from circulation, and the United States, for all practical purposes, was upon the silver standard.

This situation—legal bimetallism but in practice the silver standard—continued until 1834 when the mint ratio was

[6] During the first World War, the price of silver was high.

changed. It was altered again very slightly in 1837, but from then until 1934 continued at 15.988 to 1. This 1837 ratio, however, went too far in the other direction and was above that prevailing in the market. Gold became the cheaper metal, and silver in circulation gradually became scarcer. The United States thus, unintentionally and scarcely aware of what was happening, shifted to the gold standard. Legally bimetallism still prevailed. The mints were still open to the free coinage of silver, which was legal tender, but since the market paid a slightly better price for the metal, the market was favored as an outlet for silver.

To relieve the scarcity of small change which had developed, silver coins—with the exception of the silver dollar—were reduced in weight in 1853. They thus became token or fiduciary coins. Bullion for these light weight coins was purchased by the government, and the free coinage of silver was abolished—with the exception of that which might be brought to the mint for coining into silver dollars. Inasmuch as the amount of silver in a silver dollar cost more than $1.00, not much silver was brought for this purpose.

The complete and legal departure from bimetallism and the free coinage of silver came in 1873, when an act to revise the coinage laws dropped the silver dollar from the list of coins to be struck. The dollar, however, was the only coin to which free coinage had applied. This omission caused slight comment at the time, since the price of silver had for so long been above the point where free coinage was needed as an outlet for silver. Few persons realized the significance of what was done or were greatly interested. The act, however, closed the mints completely to silver, and was responsible for the widespread silver agitation which began shortly thereafter and has continued intermittently to recent years. Thus was born the "silver question."

By a strange coincidence, almost immediately after the Act of 1873—later known as the "Crime of 1873"—the price of silver began a long and severe decline in terms of gold, due principally to the fact that most of the advanced nations were turning away from silver and adopting gold as their monetary

standard. The more the price declined, the louder was the demand in the United States that the government do something in behalf of silver. As a result, the Treasury in 1878 was instructed by the Bland-Allison Act to purchase regularly large quantities of silver and coin it into silver dollars. Although the dollars could not be made to circulate, and the Treasury did not need this silver, the amounts were increased by the Sherman Silver Purchase Act of 1890.

The burden of these measures on the Treasury and the dwindling gold reserve was severe after 1890. The world felt that the United States was going on the silver standard as a result of the inflationary flood of silver money and of paper backed by silver. The ability to redeem all this money in gold appeared uncertain. A financial crisis ensued and the Sherman Act was repealed in 1893 at a special session of Congress called for this purpose. This did not end the agitation, and in the election of 1896 silver was the leading issue. Bryan, running on his platform of free coinage of silver at the ratio of 16:1, was defeated, and the gold standard was definitely accepted by the country.

The silver question was quiescent until during the first World War. As the war progressed, Great Britain was increasingly in need of silver to ship to India to pay for supplies purchased in that country. The United States Government had large hoards of silver lying idle in the Treasury, accumulated as a result of the silver purchase measures of the previous century. Great Britain was eager to buy, and after the United States entered the war the Pittman Act of 1918 made this silver available to the British at approximately $1 an ounce, or about double the market prices of prewar years. The United States was thus given an exceptionally favorable opportunity to rid itself of its excessive silver.

In the Act, however, was inserted a provision that all silver sold should be replaced by domestically mined silver to be bought subsequently at the fixed price of $1 an ounce. Consequently, for several years following the war the Treasury found itself buying from American producers silver which it did not need, at the high price of $1 an ounce, as compared with the market

price of 60 odd cents. For the repurchase of this silver, the Treasury spent a little over $200,000,000.[7]

United States Silver Measures Since 1929.—During the first part of 1929 silver began its long descent which carried the price to unprecedented low levels. The decline accompanied a drastic fall of commodity prices in general, but was also caused by fundamental changes regarding silver itself—particularly currency changes in India and the dumping of large quantities of Indian silver on the market. As the price of silver declined, agitation in the United States in behalf of the metal increased.

Due to the increasing severity of the economic depression during 1930, 1931, and 1932, proposals aimed to aid the silver industry obtained the support of sponsors of currency measures advocated as remedies for the business and financial disturbances. Inflationary demands from people not particularly interested in silver harmonized with proposals that the silver element in our currency be broadened, and even that the mints be reopened to the free coinage of silver.

With the continuance of the depression many persons came to feel that the monetary and credit mechanism of the country should be expanded to check the devastating deflation. This could have been done, of course, without any reference to silver. Trade with China had been disturbed by the falling price of silver, and advocates of a silver subsidy in America advanced the notion that China's purchasing power would be increased by higher prices for silver, and that this would also benefit the United States. A flood of proposals involving silver were brought forward and actively discussed. The silver measures finally adopted followed on the heels of these strong demands.

The first important measure was the Act of May 12, 1933. This Act, among other things, empowered the President to adopt bimetallism and open the mints to unlimited coinage of silver at practically any ratio to gold that he wished. He was also given the power to alter the weight of the silver dollar—as

[7] In addition, the Senate in 1924 instructed the Treasury to buy 14,590,000 ounces more at $1.00 an ounce, because some of the Treasury's silver had been used for subsidiary coins.

well as that of the gold dollar—and to receive war debt payments in silver.[8] Under authority of this Act, the President in December, 1933, announced that the Treasury would purchase all newly mined domestic silver at a price of 64.64 cents an ounce. The market price was then about 43 cents.

The administration's most far-reaching action with respect to silver was the Silver Purchase Act of June, 1934. This declared it was the policy of the United States to increase this country's silver stocks until they equaled one-third of the gold stocks. The Secretary of the Treasury was accordingly instructed to purchase silver at home or abroad until this objective was attained, or until the price of silver exceeded $1.29 an ounce. He was given discretion in regard to the time and manner of purchase, and prices to be paid. Silver certificates were to be issued against the newly acquired silver to an amount equal to not less than the cost of the metal.

This act was followed in August, 1934, by a presidential order nationalizing silver, and requiring delivery to the government of all silver in the United States, with exemptions for certain classes. The price paid by the Treasury was 50.01 cents an ounce. This order was revoked in April, 1938. The next governmental silver measure came in April, 1935, when the price to domestic producers was raised until it finally reached 77.57 cents an ounce. In December, 1937, the President extended the arrangement for the purchase of domestic silver and reduced the price to 64.64 cents an ounce. According to an Act of Congress, July 6, 1939, the Treasury was required to buy domestic silver at a price of 71.11 cents. This price continued until an Act of Congress in July, 1946, raised the price of all domestic silver mined after that date to 90.5 cents per ounce.

The intention of the Silver Purchase Act as stated therein was that silver should be acquired until one of two things happened—either silver stocks should have been raised to the point

[8] Under this provision, 22,735,000 ounces of silver were received from foreign debtor governments and credited to them at 50 cents an ounce. The market price at that time was about 34 cents. This silver was received on account of war debt payments due in June, 1933. No other payments were made, apart from $6,000 paid by Latvia.

where they were one-third of the value of the gold stocks (silver to be computed at its coinage value of $1.29 per ounce), or the price of silver should be in excess of $1.29 an ounce. Gold stocks in the country at that time amounted to about $7,800,000,000 (devalued dollars). On this basis there needed to be acquired additional silver to the extent of about $1,700,000,000 (monetary value), or a little over 1,300,000,000 ounces, compared to the approximately 700,000,000 ounces already held. This was the expensive goal set at that time by the Act. Subsequent to the Act, however, huge gold importations increased the additional silver needed. At the end of 1950 Treasury holdings of silver amounted to approximately 2.9 billion ounces with a monetary value of about $3.7 billion, but gold stocks amounted to about $23 billion. Thus in spite of large acquisitions of silver, amounting to about 2.2 billion ounces, the silver stock was still short of the goal by about 1.5 billion ounces or $2 billion.

In order to carry out the purposes of the Silver Purchase Act, the Treasury needed to acquire foreign silver, inasmuch as domestic silver production was not adequate to build the silver reserve to one-third of the gold reserve. Accordingly, the Treasury bought large amounts of silver abroad, particularly in London, where the world silver market had centered.[9] The Treasury has also bought large amounts of silver from Mexico and Canada, and formerly from China.

Under the stimulus of Treasury buying, the price of foreign silver rose in the spring of 1935 to a point where it exceeded the price being paid to domestic silver producers. The domestic price was consequently raised, as already noted. The effect was to encourage foreign speculators, who believed that the Treasury would push the world price higher and higher. In December,

[9] London bullion brokers, known as the "four just men," met and fixed the price of silver each day after all offerings and bids were received. The price was one which they believed would clear the market. All sales were to be consummated at the price for the day. When the Treasury was the principal buyer, its bid was ordinarily accepted as the quotation for the day. As a result of the war the silver market now centers in New York. Silver is considered a scarce commodity in Great Britain and its purchase, sale, and price are controlled by the government. The price is based on the New York price.

1935, the Treasury suddenly withdrew from the foreign market, and the world price of silver dropped abruptly, with repercussions in many countries. In January, 1936, the price of silver was allowed to decline to about 45 cents. During the second World War the price was about 45 cents, as noted. In July, 1951, it was about 90 cents.

During the war a large amount of silver was made available to foreign countries under lend-lease arrangements, the silver to be repaid in kind. A small amount of this silver has been returned, but in 1951 about 410 million ounces were still owing. Treasury silver was also sold to domestic industry. The silver behind the silver certificates cannot be removed and is thus not available.

The silver policy of the government during the past two decades has expressed itself in the purchase of large quantities of silver, both at home and abroad, and in the payment of prices for the metal considerably in excess of those which would have prevailed had silver been allowed to seek its own level. The excess paid has amounted to a subsidy to American silver producers. Foreign producers and sellers of silver have also benefited by the large amount of silver the United States has withdrawn from the market, and by the higher prices which have prevailed.

From the currency standpoint, the silver accumulated by the United States serves no useful purpose. For many years the Treasury has possessed excessive stocks of silver for which no monetary need exists. Silver certificates would be no less valuable if the silver behind them were removed. Other types of money could be readily substituted for them. The United States is not on the silver standard so that a silver reserve is of no more use than would be a hoard of any other commodity such as copper or nickel. The statement sometimes made, that gold needs assistance from silver, obviously has little meaning unless a country were on the bimetallic standard.

Silver and the World Economic Conference of 1933.—The price of silver is influenced by policies and events in many countries. When the government of India in 1927 changed its

currency policy and began selling silver in order to build up a gold reserve, and the price of silver accordingly began to decline, objections were raised in various parts of the world—particularly by silver producers within the United States. The instability in silver was also detrimental to China then on the silver standard. As the depression beginning in 1929 grew worse, the price of silver fell lower and lower, and the demands that the United States Government "do something for silver" became more insistent. The Democratic Administration which took office in March, 1933, was pledged in its platform to "an international monetary conference called on the invitation of our Government to consider the rehabilitation of silver and related questions."

The movement for international cooperation to rehabilitate silver culminated in May, 1933, when Senator Key Pittman of Nevada announced that all the countries participating in the discussions at Washington preliminary to the World Economic and Monetary Conference, about to convene in London, had agreed in principle upon plans regarding silver. This announcement coincided with joint statements issued by the President and by the Mexican and Chinese Ministers of Finance, expressing a favorable attitude toward enhancement and stabilization of the price of silver.

The principal purpose of the conference was to stabilize currencies and exchange rates, and to free trade from some of the numerous restrictions that handicapped it. Although the conference as a whole was a failure, as discussed in Chapter 38, it passed a resolution on silver. The resolution, introduced by the United States delegation, was approved unanimously by the delegates of the 66 nations, July 20, 1933. It recommended that nations using, producing, or holding silver make an agreement with a view to mitigating the fluctuations in the price of silver; that they refrain from further debasement of silver coinage, and that they substitute silver for low value paper currency.[10]

[10] The resolution reads:
"Be It Resolved to Recommend to All Governments Parties to This Conference:
"A.—That agreement be sought between the chief silver-producing countries and those countries which are the largest holders or users of silver with

The agreement recommended in the resolution was signed outside the conference a few days later, July 22, 1933, by representatives of eight nations—the United States, Canada, Mexico, Australia, and Peru (silver producers), and India, China, and Spain (holders of silver). The agreement provided among other things that India limit her annual sales of silver, and that other nations withdraw from the market annually a certain amount of their mine production.

Neither the resolution nor the subsequent agreement made any mention of raising the price of silver. The agreement was made "with a view to mitigating the fluctuations in the price of silver, and that other nations not parties to this agreement should refrain from measures which could appreciably affect the silver market." The subsequent silver measures of the United States, sponsor of the agreement, were criticized as not in harmony with this aim of stabilization and the avoidance of measures which would "appreciably affect the silver market." Beginning in 1936, however, the United States did stabilize the price of silver.

In the President's Proclamation of December 21, 1933, regarding the purchase of domestically mined silver, he announced that he had ratified the above agreement. India, he stated, had already put the agreement into effect. Of the 66 nations that

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a view to mitigating the fluctuations in the price of silver, and that other nations not parties to this agreement should refrain from measures which could appreciably affect the silver market;

"B.—That Governments parties to this Conference shall refrain from new legislative measures which would involve further debasement of their silver coinage below a fineness of 800-1,000;

"C.—That they shall substitute silver coins for low-value paper currency insofar as the budgetary and local conditions of each country will permit;

"D.—That all provisions of this resolution are subject to the following exceptions and limitations:

"Requirements that such provisions shall lapse April 1, 1934, if the agreement recommended in paragraph A does not come into force by that date, and in no case shall they extend beyond Jan. 1, 1938.

"The Governments may take any action relative to their silver coinage they deem necessary to prevent the flight or destruction of their silver coinage by reason of a rise in the bullion price of the silver content in their coin above the normal or parity value of such silver coin."

—*Commercial and Financial Chronicle,* July 29, 1933, p. 777.

agreed unanimously to the resolution, the majority did not produce any silver and were not much interested in silver. Many had no silver coins in circulation, but used nickel, copper, or bronze for minor coins and paper for larger denominations. Others had only small amounts of silver in their coins because of a reduction in the silver content of the coins. Few of the countries were buyers or potential buyers of silver.

Several of these countries, however, possessed large stocks of silver which they were desirous of selling. The producers of silver, such as Australia, Canada, Mexico, and Peru, were, of course, willing to support the United States in plans to prevent further dumping of silver hoards on the world's markets and to bring about an absorption of part of the silver output.

China, as the only large nation on the silver standard, desired stabilization of the price of the metal. The drastic declines in price which had taken place had been upsetting to China's foreign-exchange rates and trade. It was China's hope that a checking of the sales of silver from India and elsewhere, and the absorption of silver by the United States, would halt the decline and thereby benefit China. The subsequent sharp and extensive rise in price, maneuvered by the United States and which was so harmful to China, was not desired, as can be seen by the discussion below.

China Abandons Silver Standard.—In China, until shortly before the second World War, money for centuries had consisted largely of silver and, conversely, silver, even in bullion form, was money. Copper coins were used by the great mass of the people for their small purchases, but silver constituted the principal monetary standard and was used for most purchases of size.[11] It was used by banks for reserves, and was hoarded extensively by persons fortunate enough to possess it.

As the American silver program got under way during the 1930's and the Treasury offered higher and higher prices, China saw its money drawn to the United States. China had normally been a silver-importing nation—a buyer and not a

[11] For a discussion of the different currency standards prevailing in China, cf. Frank Whitson Fetter, "China and the Flow of Silver," *The Geographical Review*, Jan., 1936.

seller of the metal—absorbing large quantities in exchange for tea, silk, and other goods. Silver stocks in Shanghai declined from about 440,000,000 ounces at the end of 1933 to 257,000,000 in March, 1935. Its exodus meant a contraction of the country's currency supply and left closed banks, severe depression, bankruptcies and stagnant trade.[12]

China had gone through an inflationary boom from about 1926 to the latter part of 1931, due principally to large accumulations of silver in the reserves of the banks and to the cheapening of the metal throughout the world. Silver came to Shanghai from the interior for protection and because business was dull due to political disturbances. Silver also came in from abroad. In Shanghai silver stocks had increased from about 101,000,000 ounces in January, 1926, to 449,000,000 in June, 1934. As a result, money was plentiful and commodity prices rose in China.

Figure 6 shows the course of commodity prices in Shanghai during this period, the peak in 1931, and the fall that took place from then until 1935. It shows also the world price of silver, and commodity prices in the United States. It will be noted that commodity and silver prices in China tended to move inversely.

China, with rising commodity prices, enjoyed prosperity when the gold standard world was suffering from falling prices and depression. Although prices abroad were low, China was able to sell outside its borders because foreign gold values could be converted into a large amount of Chinese currency at favorable exchange rates due to the cheapening of silver in terms of gold.[13]

[12] Handy and Harman, *Annual Review of the Silver Market* for 1935.

[13] The fall in the price of silver, in terms of gold, in 1929, 1930, and 1931 also contributed to the rise in commodity prices in China by making foreign goods more expensive. Exchange rates on gold countries rose as silver fell, and thus made foreign goods more costly in China. To most of the world, silver was merely a commodity and its price fell along with those of other commodities, in fact, fell more rapidly than most. Figure 6 shows how silver fell from 60 to 27 cents an ounce during the period when commodity prices in the United States were falling from about 98 to 75 (and then to 60.) In China, where silver was used as a currency unit, this greater fall of silver—a cheapening of silver in terms of foreign commodities—meant that foreign goods cost a larger amount of silver. Domestic prices within China, however, had been rising due largely to the inflationary movement.

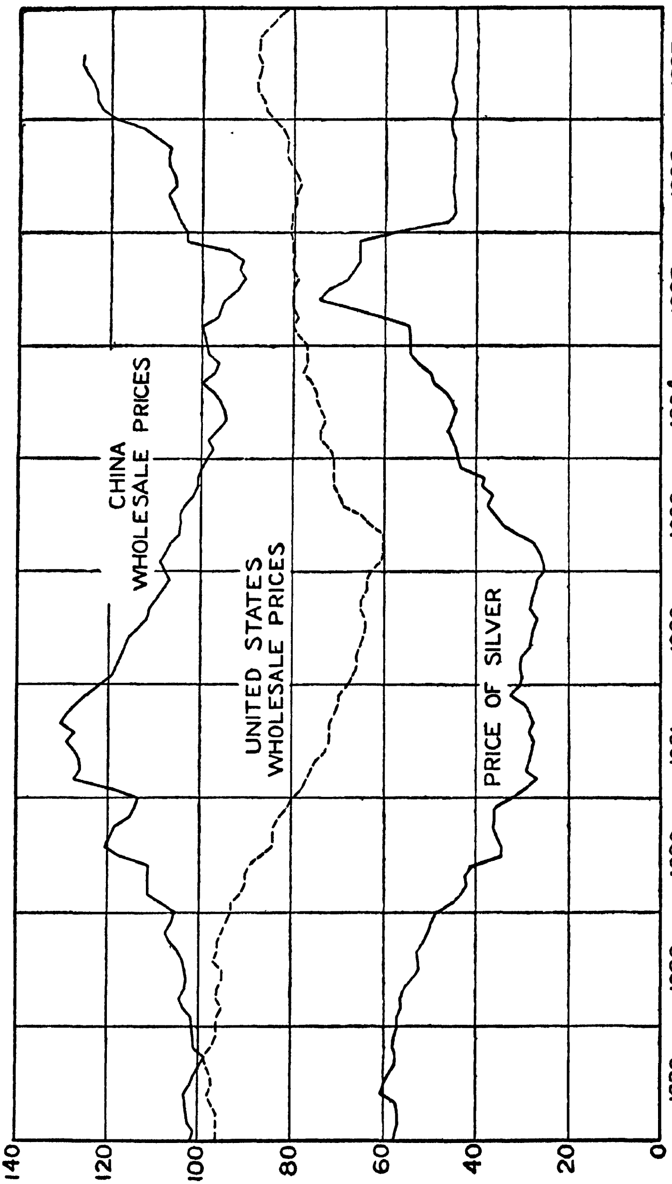


FIG. 6.—Prices of Silver and Wholesale Prices in China and the United States from 1928 to 1938.

(Silver in cents per fine ounce. Price indices 1926 = 100. For China, wholesale prices in Shanghai. For United States, Bureau of Labor Index. Sources: National Tariff Commission, Shanghai; League of Nations, *Monthly Bulletin of Statistics*. B. of L. Statistics.)

The commodity price level in China stopped rising and began to decline in the fall of 1931, as can be seen in the chart. This decline coincided with Britain's departure from gold in September of that year. The pound sterling promptly depreciated abroad and the price of silver, which had already stopped falling, turned upward. The rise in silver was short-lived, but its long decline had come to an end and, with it, the boom in China. The ending of silver's decline was due primarily to prospects regarding American assistance to the metal and to the halt of commodity price declines in Britain once that country left gold. Commodity prices throughout the gold standard world, however, continued downward for another year. This change in the trend of Chinese commodity prices marked the end of inflationary prosperity there. A downswing of business in China was thus in process when the United States started actively to boost silver. As the price of silver rose, China's depression became increasingly severe. Falling silver had been unhealthily stimulating to China, and an ending of the decline ended the prosperity. The rising price of silver, on the other hand, had depressing effects. As it continued, it led to severe economic disorders; banks saw their cash reserves depleted by withdrawals of the metal for shipment abroad. As large reserves had financed the boom and rising prices, so reduced reserves and a contraction of the currency spelled deflation, falling prices, and depression. While the American silver program cannot be blamed for originating the depression in China, nevertheless a rising silver price appears to have been a principal factor responsible for China's grave economic troubles after early 1933, culminating in the disruption of its currency system.

It had been contended in the United States that a rise in the price of silver would stimulate merchandise exports to China by increasing the value of China's money in terms of United States dollars and other foreign currencies. These expectations, denied by economists, were not borne out by later experience. Exchange rates in China on foreign countries began to rise in 1933, along with the rise in silver. In 1933 there were 28.60 American cents to a Chinese yuan; in 1934, 34.09. This rise in exchange rates, instead of helping China's trade, proved

disturbing. Chinese exporters found their sales yielding less in Chinese money, so that exports were discouraged. Importers, on the other hand, were unable to sell as much as formerly, although foreign goods became cheaper as silver rose. They sold less because of depressed conditions within China and the reduction of monetary incomes which accompanied the drastic deflation. Foreign trade thus declined sharply.

In 1935 China's total foreign trade amounted to only about 66 per cent of the 1931 level. The loss was evenly divided between exports and imports. While trade between the United States and most of the world increased after 1933, this country's trade with China declined, due principally to the severe economic disturbances within China, attributable in large measure to high-priced silver which resulted from the American silver-buying program.

As the American silver program progressed, China became increasingly fearful of its effects upon her economy. The Chinese Government early protested to the United States Government. In February, 1934, Dr. H. H. Kung, Minister of Finance, informally brought to the attention of the United States Government the probable detrimental effects upon China of the projected rise in the price of silver. On August 19, the following communication was sent to President Roosevelt by Minister Kung:

> The London Silver Agreement of July, 1933, received the signature of China's representatives and has more recently been ratified by the National Government of the Republic of China with the understanding that its major purpose was to assure the stability of the price of silver which was thought menaced by the large surplus stocks held by the Governments of India and Spain. The preamble of the Agreement states in part that "it is to the advantage of China that sales from monetary stocks of silver be offset by purchases as herein provided, with a view to its effective stabilization."
>
> It now appears that under the Silver Purchase Act of 1934 the stability of the price of silver and the interests of China are as much menaced as by the previous situation of potential sellers. China would therefore appreciate an indication of the probable policy of America in the future purchase of silver in order that China may properly safe-

guard her currency, which has recently been flowing out of the country to a degree that is potentially alarming.[14]

The reply of the United States, dispatched September 22, after referring to this government's policy of increasing its holdings of silver, said that the government was thus endeavoring to expand the monetary use of silver as recommended by the resolution adopted in London.

On the next day, September 23, 1934, Minister Sze sent a communication to the United States Government outlining the economic dislocation which the American silver policy was producing in China. The note said that China was obliged to consider changing the country's currency system, and the gradual adoption of a gold-basis currency.

To this communication the United States Government replied, October 12, 1934, that the silver buying program was embodied in an act of Congress and was mandatory upon the Executive. It continued: ". . . this Government, while necessarily keeping within the general purpose of the enactment, will give the closest possible attention to the possibilities of so arranging the time, place and quantity of its purchases as will keep in view the considerations put forward by the Chinese Government in its communications." [15]

China became convinced that it could expect no relaxation of the American silver policy, which was playing havoc with its economic affairs. On October 15, China endeavored to stem the outflow of silver, halt further appreciation of the Chinese silver dollar, and stay the depression by imposing an export levy of 10 per cent upon exportation of silver plus an equalization charge that varied with the price of silver. By this measure the Chinese currency was separated from the price of silver, and exchange rates no longer fluctuated in accordance with world silver prices. The measure helped somewhat, but was not entirely effective because of the difficulties of enforcement.

The price of silver continued to rise. At the time of the above communications in the fall of 1934, it was around 50

[14] Kuo Min News Agency, Oct. 16, 1934.
[15] *Ibid.*, Oct. 14, 1934.

cents an ounce, while in May, 1935, it rose to 81 cents. Silver was smuggled out of China in spite of government restrictions. China's problem thus continued acute. The silver standard was finally abandoned on November 4, 1935, when a managed currency with a foreign exchange standard was substituted for China's historic silver standard. The British colony of Hong Kong took similar action.[16]

China's action dealt a severe blow to silver, since China for generations had absorbed large quantities of the metal. It brought to an end, at least for the present and probably permanently, the long history of silver as a currency standard. It also left the United States Treasury the principal buyer of a metal which other nations did not want. China had wished to leave silver for several years and had been making plans in this direction, but the American silver program compelled the step.

[16] In announcing the change Minister of Finance H. H. Kung, after recounting the disturbances suffered by China and referring to his country's efforts to check the outflow of silver, said:

"It was, however, clear at the outset that the measure adopted could only be temporarily effective; as long as the value of the currency remained high, deflation would continue and with increased severity; should the value fall and create a wide disparity between the domestic and foreign price of silver—as in fact has happened—extensive smuggling of silver would result.

"In order to conserve the currency reserves of the country and to effect lasting measures of currency and banking reform, the Government, following the precedents of many countries in recent years, has decreed, with effect from November 4, 1935, as follows:

"1. The banknotes issued by the three Government banks, . . . shall be full legal tender. . . . The notes of all other issuing banks . . . will gradually be withdrawn . . . their bank note reserves are to be deposited with the Central Bank.

"2. All debts expressed in terms of silver shall be discharged by the payment in legal tender notes of the nominal amount due.

"3. All holders of silver are required to exchange their silver for legal tender notes.

"4. The exchange value of the Chinese dollar will be kept stable at its present level, and for this purpose the Government banks will buy and sell foreign exchange in unlimited quantities.

"The Government-owned Central Bank is to be reorganized as the Central Reserve Bank of China . . . devoting itself chiefly to maintaining the stability of the nation's currency. . . . After a period of two years (it) will enjoy the sole right of note issue."

Currency Reserve Board, *The Monetary Policy of China*, Shanghai, Jan. 15, 1936.

At the request of the United States, representatives of the Chinese Government conferred in Washington with the United States Government in April, 1936, regarding the silver program. On May 18 announcement was made that an agreement had been reached whereby the United States would purchase considerable amounts of silver from China. The American dollar proceeds were to be maintained chiefly in New York and were to be available to assist in the stabilization of China's managed currency. In July, 1937, this agreement was reaffirmed, and announcement made that additional gold would be given China in exchange for silver. The United States had on two previous occasions purchased large amounts of silver from China which were helpful to China.[17] China issued a statement, in connection with the 1936 agreement, which declared that China's currency was to be independent and not linked to any foreign unit. Great Britain, it was reported, had been endeavoring to have the Chinese yuan linked to the pound.

China's managed currency functioned satisfactorily, but had existed less than two years when the country was attacked by Japan. In spite of this disaster the stability of the currency was maintained for a considerable period. Exchange rates on New York remained at a little over 29 cents per yuan, China having acquired substantial currency reserves abroad, until the spring of 1938 when the rates sagged. As the war continued and most of the world became involved, China's currency depreciated considerably, reflecting the critical situation and extensive inflation.

[17] In November, 1934, 19,000,000 ounces and in November, 1935, 50,000,000 were bought. *New York Times,* May 19, 1936

Chapter 27

FOREIGN INVESTMENT

Nature of Foreign Investment.—Foreign investment differs from domestic investment in a number of ways. When capital crosses a border it becomes subject to foreign laws, taxes, policies, and conditions, and must contend with hazards of a different type than pertain to domestic investment. For example, the transfer of earnings on the investment into the owner's currency, or the return of the original capital, may be restricted and at times denied entirely. War may affect foreign investments more directly than domestic investments. Foreign investment also raises problems for governments regarding the rights of their nationals and companies investing abroad, and the treatment to be accorded them by the foreign government, as well as problems of a different sort for the government of the recipient country.

When capital seeks investment in foreign countries the reason is usually that the returns there appear higher than at home. In some cases the returns are, in fact, less than at home but the funds are considered safer abroad due to political or other uncertainties at home. Capital thus seeks investment in the United States or other countries where it is considered secure. Investors may also place their money abroad for purposes of diversification and to avoid a concentration of risks. Ordinarily, however, capital is attracted by prospects for a good return as noted, and tends to flow from advanced countries to the less developed areas where interest rates and profits are higher.

In advanced countries savings and capital accumulations are greater than in underdeveloped areas, and as a result profits and interest rates in such advanced countries are lower. In underdeveloped parts of the world opportunities commonly

exist for the profitable utilization of funds. Tools and equipment are primitive or inadequate so that capital invested in supplying them may increase production materially and receive good returns, provided other necessary conditions are present as noted below. Modern farm equipment, for example, may greatly increase grain production, and provide generous returns on money invested.

A portion of the high returns in underdeveloped areas is traceable to the greater hazards which tend to deter capital investment. If those hazards did not exist capital would tend to flow in from abroad and to equalize returns. In some parts of the world banks charge borrowers from 10 per cent to 20 per cent interest or even more. Foreign capital, however, may not wish to enter the country, so that the lenders there are able to obtain high rates of interest.

Nations in their evolution from a condition of underdevelopment to a more advanced status pass through several different stages from the standpoint of foreign investment, according to John E. Cairnes writing about eighty years ago. In the early years, according to the analysis of Cairnes, a country borrows or receives investment capital from abroad. It has an excess of imports of goods and services in its balance of payments, representing the receipt of such capital. Interest and dividend payments due abroad on the capital gradually increase, and together with repayment of principal eventually equal and then exceed the volume of new capital currently being received. Such excess of payments due abroad over current capital receipts results in a reversal of the former import balance in the country's foreign trade. The country thus develops a surplus in its foreign trade. Finally, the country not only repays its borrowed capital, but as it becomes more advanced it lends and otherwise invests abroad. This outflow of capital results in a continuation of the surplus in its balance of payments.[1]

[1] John Elliot Cairnes (1832-1875) in his *Some Leading Principles of Political Economy* (1874), thus distinguished (*a*) a borrowing period, (*b*) an intermediate period when interest payments offset new capital imports, and (*c*) a period in which interest payments plus capital repayments exceeded new loans, resulting in a favorable balance.

This analysis, although exemplified by the experience of the United States, does not fit all countries nor conditions today. In the first place foreign investment takes the form, to a large extent, of direct investments which remain indefinitely in the country, rather than of loans which are repaid. Moreover, interest, dividends, and capital transactions (apart from flight capital transactions) are often overshadowed by other items in the balance of payments, and by themselves may not be responsible for a surplus or deficit.

Foreign investment takes two general forms. The investment may be in the form of a loan or credit to a foreign borrower, in which case the investor has little or no control over the use of the money, or it may be in the form of direct ownership and operation of foreign property, a factory, mine, assembly plant, sales agency, etc. The former type of investments, namely loans of money, are known as *indirect* or *portfolio* investments, whereas the latter type are known as *direct investments.*

When bonds or other obligations are made payable in the borrower's own currency the loan is called *internal,* since most of the purchasers are ordinarily domestic. If the securities, on the other hand, are in terms of a foreign currency such as the dollar, pound sterling, franc, or guilder, presumably that of the lender, the loan is called *external.* Foreign investors sometimes purchase internal securities, payable in local foreign currency, but usually prefer securities payable in dollars or in their own currency so as to avoid exchange rate and transfer difficulties.

Loans may be made to foreign governments, provinces, and municipalities, or to private foreign corporations and individuals. In the case of loans from one government to another government the motives of the lending government are different from those of private investors, who in extending loans are impelled primarily by the desire for a return on their money. Governments do not make loans in order to earn interest. The purposes and end results of government loans, however, are frequently the same as in the case of privately made loans. Government-to-government loans are commonly made to pro-

mote economic development, to improve transportation or for some other public purpose, or perhaps to meet some emergency need in the borrowing country. Private loans to governments are for essentially these same purposes, although they are not ordinarily influenced by political objectives as in the case of government-to-government loans.

Privately made foreign loans have not been very numerous since the beginning of the 1930's as noted below. Most foreign investments in recent years have taken the form of direct investments, such as for petroleum development in Latin America and the Middle East. The interest rates obtainable upon loans have not been sufficiently high to compensate for the estimated risks in lending money. Governments in the light of public opinion and national prestige could not pay more than 5 or perhaps 6 per cent interest. This rate of return has been inadequate to attract lenders. Certain direct investments, however, permit the investor to earn good profits commensurate with the high returns customary in most foreign countries, and required by foreign investors if they are to risk their capital. The high return required, however, practically eliminates certain fields of endeavor, particularly public utilities, transportation, etc.

Effects of Capital Transfers.—When capital is transferred, often quickly by cable or by a piece of paper, the question arises as to just what it is that moves. It was noted previously that capital is transferred by the movement of merchandise, the precious metals, or the rendering of services. Yet capital movements are often referred to as taking place suddenly by wire, or by mail. When huge sums are transferred in a short space of time, gold or merchandise has not had a chance to move nor could services have been rendered.

The question of capital movements is confused by the fact that the word capital is commonly used with different meanings. First, it is used in the sense of physical wealth—steel, wheat, lumber, machinery, etc.—and second, in the sense of money, securities, or other claims to wealth—ownership of the physical wealth or "real" capital. Ownership can, of course, be trans-

ferred instantaneously, and this is what happens when capital is said to move quickly. Transfer of ownership is usually followed, however, by movements of physical wealth or services. The confusion is thus between the transfer of physical capital and the transfer of claims to such capital.

Transfers of ownership involve acquisition by foreigners of physical or real capital already in a country. For example, Europeans might acquire title to American securities or bank deposits, which represent title to wealth in America, and may give in exchange title to European wealth. America in this case has received no new wealth. America has merely exchanged ownership in its own real capital for that in European wealth. On the other hand, should Europeans acquire capital here through exportation of gold to America or by sending merchandise or rendering services, the net wealth of America would thereby be increased. An inflow of capital means that foreign ownership of the physical or real capital of a country is increased. Such increase may be accompanied either by the receipt of physical capital or of title to such physical capital abroad.

When it is said that capital comes to America quickly, funds in America change ownership. Americans give dollars in exchange for some foreign currency or other items of value, perhaps an I.O.U. No new real capital comes to America, however, until gold, goods, or services are received. For example, if events in Europe cause a flight of capital from Paris to New York (and the capital is permitted to leave France), persons in Paris offer francs in exchange for bills in New York. The dollar is in strong demand. The dollar real capital represented by the bills in New York bought in Paris, however, is already in America. It may be owned by Americans who exchange title to it for francs, or it may be already owned by certain foreigners who sell to other foreigners; but the real capital is in America. It may be owned by a French exporter of goods to America. The dollars sold in Paris may come from the sale in America of securities owned by persons in France, who then sell their American dollars (claims to American real capital) for francs. The dollars may come from someone in a third country who sells his dollars for francs. The dollars may represent money

loaned by New York banks, in which case French banks draw bills on the New York banks and sell the bills. In any event, all that changes in the first instance is the ownership of capital already in America. Americans or foreigners have given up their title to American dollars in exchange for francs or other currencies.

This situation would probably lead to the importation of goods or gold into America. Only when gold or merchandise is shipped to this country, or services are rendered, can new real capital find its way to America. However, capital already in America can pass suddenly into the hands of foreign owners.

A large amount of liquid money capital, in the shape of claims to wealth or real capital, exists in the form of bank balances, short-term evidences of debt, or securities which are readily marketable in almost any of the financial centers of the world. These transferable claims to wealth permit the quick movement of money capital from country to country. Such movements have placed severe burdens on foreign exchange reserves and rates, and have led to restrictions on capital movements.

Capital exports tend to increase a country's exports of merchandise and services, as already noted, and may have other important effects. Enlarged merchandise exports may stimulate domestic activity and contribute to greater employment and output. (See Chapter 9, "National Income and the Foreign Trade Multiplier.") It has sometimes been charged that, in periods of unemployment, measures to stimulate exports through increased foreign loans and investments, or other means, constitute the "export of unemployment." Such charges are a distortion of the situation when they were on occasion applied to United States loans and grants in the years following the second World War. United States efforts to encourage private foreign investment have been motivated by the desire to facilitate economic development in foreign countries, and to help finance the already large United States exports which are needed by other countries, and which have been financed to a large extent by the United States Government. A substantial contraction in exports might, of course, have depressing effects upon

the United States economy, but this fact has not been an important part of the problem. During the rearmament program the United States did not need to be concerned about the flow of exports in order to maintain employment at home.

Tied Loans.—The outflow of capital tends to increase a country's exports in the direction of the country receiving the capital, which latter country accordingly tends to have an increase in imports. However, dollars loaned abroad may not necessarily be spent by the borrowing country in the United States, but might be transferred to a third country in exchange for the currency of such country. The borrowing country might desire to import from a third country, so that the United States exports resulting from the loan would not necessarily be directed to the borrowing country. The dollars may not be spent at all but may be held as part of the monetary reserve, in which case they would not affect trade, at least directly.

Foreign loans sometimes carry a provision that the funds must be spent by the recipient in the country making the loan. They may not be transferred to a holder in a third country and thus used to purchase goods from the third country. Such loans are known as "tied loans." Loans by the United States Export-Import Bank have commonly been of this nature, in view of the Bank's interpretation of the desire of Congress with respect to the Bank's loans.

A tying clause in a loan contract is, of course, not in the best interests of the borrower, who may be able to purchase more advantageously in a third country. Nor is it likely to benefit the lending country since the dollars will sooner or later be spent by some holder of them, whether in the borrowing country or some other country. In the event that they are loaned as free dollars, and are transferred to a third country and not spent immediately but used to add to reserves, they thereby strengthen the reserve position of the foreign country with indirect benefits to the United States. Tied loans were originally the result of a lack of understanding of the multilateral nature of international trade, and represented a desire to assure that the lending country's exporters benefited by the loan.

History of United States Foreign Investments.—After the Revolutionary War and the establishment of independence, the United States was economically exhausted and its financial condition precarious. The continental currency, printed to finance the war, had depreciated to the point where it was all but worthless, and the country was burdened with debts which at that time seemed very large. The new country's credit in foreign capital markets was so low that requests for loans from the political enemies of Great Britain met with polite refusals.[2]

This condition of low credit standing in the eyes of foreign lenders, however, did not last many years, although the United States Government no longer was interested in foreign borrowing. The Industrial Revolution, involving substitution of machines for hand labor and of factories for home production, was under way in England and was expanding production rapidly, permitting increased savings and the accumulation of wealth. It was not long before the new capitalist classes in England and in Europe, seeking greater returns for their surplus funds, turned their attention to America which offered attractive opportunities for investment. Capital came to the United States early in the nineteenth century and by 1850 foreign investments in this country amounted to about $250,000,000.[3] In 1910 foreign capital in the United States was estimated to have amounted to about $6,500,000,000, more than half of which was from Great Britain.[4]

The economic development of the United States was financed to a considerable extent by foreign capital. In the early period money from foreign loans, usually to state and local governments, built highways, bridges, and canals. The profitable Erie Canal was built largely with foreign money. After the Civil War, the railroad expansion which took place was financed mainly with capital from Great Britain, the Netherlands, and Germany. At the time of the first World War approximately $4 billion of United States railroad bonds were still held abroad.

[2] A loan of $195,000 was made by France during the war.

[3] *Foreign Investments in the United States* (Washington, D. C.: United States Bureau of Foreign and Domestic Commerce, 1937), p. 22.

[4] *Ibid.*, p. 23.

The development of cotton and sugar plantations in the South was also financed to a considerable extent by foreign money which was loaned to growers through local banks. Petroleum and other mineral resources were similarly developed with the aid of foreign capital.

Prior to 1874, the United States had a deficit in its balance of trade, which largely represented new capital coming to this country. From this date, however, until the present time, the balance of trade has, with two exceptions, regularly shown an annual excess of exports, representing, in part, interest and principal payments by this country and later new capital exports from this country.

During most of the country's history the United States was, as noted, the recipient of foreign capital, rather than the source of capital for other countries. It was about 1900 that American capital began to flow out of this country in sizable amounts into foreign countries. The capital went principally into the neighboring countries of Canada, Mexico, and Cuba in agricultural and industrial enterprises. In 1914, American investments abroad totaled about $2⅓ billion. However, investments in the United States by foreigners amounted to about $6 billion, so that this country was a net debtor to the extent of something over $3½ billion.[5]

The first World War, however, changed this situation. The United States loaned large sums to Europe before it entered the war, during the war, and after the war, so that it became a creditor nation. In the first place, upon the outbreak of the war in 1914, large amounts of American securities owned by foreigners were sold in this country in order to secure American dollars to aid in financing the war. This resale to Americans during the course of the war amounted in all to about $2 billion. In the second place, the interruption of industry in Europe stimulated American exports, the financing of which was accomplished at first largely by private loans to Europe and, later, after America's entry into the war, by much larger United States Government loans to the various allied nations.

[5] *Op. cit.* A discussion of the different estimates of foreign capital in America appears on page 24 of the Commerce Department study.

When hostilities ceased, the United States, instead of being a debtor to other countries, was a net creditor to the extent of over $10 billion. Three-fourths of the debt to the United States, however, represented obligations of the allied governments to the government of the United States. These war debts may be written off and considered similar to lend-lease aid of the second World War. The first World War suddenly thrust the United States to the fore in international financial affairs. The American dollar was practically everywhere regarded as a safe and reliable currency, partly because of the inflation and disturbed conditions in Europe, but also because of the wealth and political stability in the United States. America, moreover, had capital available for investment in foreign countries.

The British public long ago became familiar with the foreign market as an outlet for funds, but the American public learned of it during and after the first World War. In typical American fashion the country went to the extreme in a scramble to lend money to foreigners. During the 1920's, particularly 1925-30, investment houses, anxious for the lucrative commissions on floating loans, vied with each other to find foreign borrowers—governments, cities, or private businesses. Agents with fat expense accounts were sent abroad, especially to Latin-American countries, to persuade officials there that they could use American money. The officials were not reluctant to see money coming into the treasury; some purpose for the money could usually be discovered. Several billion American dollars were poured into securities issued by national, provincial, and local governments and by private corporations in Europe, Latin America, Australia, Canada, and the Far East.

The bonds of these foreign governments or corporations were sold to the inexperienced American public, attracted by the high return. In some cases the bonds yielded 8 per cent or more. At its peak the foreign bond holdings of the United States amounted to slightly over $11 billion. When the borrowing countries began defaulting in their interest payments during the 1930's, and when the securities declined in value, the losses to American investors were heavy. About one-third of

the bonds went into default.[6] Had there been no severe depression the history of these bonds would doubtless have been different. As depression gave way to recovery, most of these foreign securities improved in value. Readjustments were ultimately made in most cases, but generally on a basis of reduced payments. In spite of the losses and reductions in income on individual issues, Commerce Department studies have shown that when all United States foreign investments during the twenty-year period 1920-40 are taken together, the result of these investments was not unprofitable.[7]

The foreign bond investment experience of the United States had unfortunate consequences. It did not increase international good feeling. The borrowers blamed the United States for lending so much money on a reckless basis, whereas the American creditors did not believe the borrowers were making proper efforts to pay their obligations. Moreover, American investors swung from the position of free and easy lending, to one of extreme caution in lending or otherwise investing abroad. The cessation of the flow of new American investment abroad and the effect on the American export industries added to the severity of the depression.

The United States position as a net creditor nation on capital account was weakened during the depression as a result of the decline in the value of United States foreign holdings, and also as a result of an influx of foreign funds into the United States beginning about 1934. The threatening political situation in Europe caused foreign capital to seek a haven in the United States. After the invasion of France in 1940 the inflow of foreign money was especially large, and total foreign assets here at the end of 1940 reached a peak, up to that time, of $9.7

[6] An investigation by the Senate Finance Committee into the bond flotations took place in 1932 and uncovered various abuses. Legislation was adopted in 1933 and 1934, applicable to both domestic and foreign investment, designed to prevent such abuses.

[7] The total amount of money received as interest, dividends, and repayment of principal on United States foreign investments from 1920 to the end of 1940, plus the value of investments still held in 1940, amounted to $23.7 billion, which compares with an amount originally invested of $13.4 billion (*Survey of Current Business,* Nov., 1944).

billion. The former large outflow of American money at the same time declined to almost nothing; in fact, American money was called home. During the years 1942-45 foreign countries, particularly Latin-American countries, accumulated about $6.2 billion here in gold and short-term dollar assets, largely as a result of heavy United States purchases abroad of materials needed for the conduct of the war.

After the second World War the investment of new United States funds abroad showed some revival, but was still small. In the period since the war American foreign investment has been desired by foreign countries and by the United States Government, in view of the contribution it can make to economic development and to the needs of foreign countries for United States dollars, but the volume of such investment has not been large.

The outflow of American capital during 1946-49 totaled approximately $3.5 billion. The total value of United States private investments of all kinds in foreign countries amounted at the end of 1949 to $19.112 billion. If United States Government holdings of foreign obligations are included, the figure becomes $32.643 billion (excluding the so-called war debts). Foreign private capital in the United States, especially short-term funds, declined after the war as the countries needed dollars to pay for large imports from the United States. At the end of 1949 such foreign private capital amounted to $13.784 billion, which meant that the United States was a net creditor on private account to the amount of $5.3 billion. Foreign government funds in the United States, including bank reserves, raised the above figure of foreign capital here to $17.624 billion. On total government and private account the United States was thus a net creditor to the amount of $15.019 billion. Private capital is currently flowing abroad at the rate of approximately a billion dollars a year.

In 1949 the income on United States private investments abroad amounted to $1.307 billion, and on United States Government holdings to $98 million. About $495 million of the private earnings were reinvested abroad. United States payments to foreigners on their investments here amounted to about

\$328 million in 1949, of which \$143 million was reinvested in the United States.

New United States foreign investments since the second World War have consisted almost entirely of direct investments, in contrast to the bond obligations which constituted about 60 per cent of United States investments during the 1920's. The recent investments have been made almost entirely by corporations and largely to expand previously existing undertakings. The bulk of the investments have been made by a relatively few corporations, and largely for petroleum development in Latin America and the Middle East. Money has also been invested abroad for manufacturing, mining and smelting, agriculture, and distribution facilities.

American factories and assembly plants in foreign countries find an economy in locating close to the foreign market, or near raw materials. Labor costs abroad are also less, and goodwill usually attaches to an article produced within the country. Furthermore, production abroad makes it possible to avoid tariffs on goods sold in the local foreign market. For these reasons a number of United States corporations have established branches and assembly plants abroad.

Conditions since the war have not been conducive to much private foreign lending, although foreign governments have desired to borrow. In view of the dearth of new private investment, government lending has helped to meet the need of foreign countries for such investment, and of the United States to help finance exports. Private foreign lending can perform a useful function and may again become important.[8]

[8] Although few public offerings of foreign securities have been made in the United States or elsewhere in recent years the machinery for such offerings exists. The procedure involves an agreement between the foreign borrower and the investment banking house regarding the terms of the new issue, interest rate, maturity, net amount of money to be received by the borrower, etc. The banking house generally agrees to buy the entire issue at a price slightly below that at which the obligation will be offered to the public. The banking house will ordinarily be joined by several other houses in the form of a syndicate, since no one house would care to assume the entire risk of loss in the event the issue proved difficult to sell. Security dealers and brokers throughout the country then act as middlemen in selling the issue to ultimate investors.

Deterrents to Foreign Investment.—The outflow of United States investment capital, as noted above, has been small at a time when foreign countries have desired capital to facilitate their economic development, and when the United States Government has itself been called upon to supply dollars to foreign countries to help pay for their imports from the United States. United States agricultural and manufacturing industries are geared to large exports and regularly produce more commodities than can be consumed within the United States. This country has long had an excess of exports which must be financed by an outflow of capital or by some other means. Opportunities for profitable investment within the United States are abundant and earnings good so that in recent years capital has in general preferred to stay at home. The export surplus has been financed by the government, or in another sense has been due to government financial aid to foreign countries.

The failure of capital to take advantage of opportunities for profit abroad that appear reasonably promising on business grounds is due to a number of deterrents which are principally as follows:

1. *Threats of war:* The international political situation has continued so disturbed that most investors have not been inclined to place their funds outside their own borders.

2. *A socialistic trend in some countries with consequent fear by investors of expropriation or government competition:* Governments have increasingly become owners and operators of enterprises. They have taken over properties and have not always paid the owners adequate compensation. A foreign investor does not wish to build up an enterprise, with the risks involved, if there is a possibility that the government may expropriate him, and especially if it appears that the compensation may be inadequate.

Governments also embark upon undertakings which offer competition to existing enterprises. Investors feel that government competition is likely to be unfair in that the government will favor its own enterprises through tax exemption or

other means, and that the government may accept losses in order to maintain a low price of the product.

3. *Burdensome regulations and attempts or threats of measures to limit profits:* Governments have increasingly regulated economic activities including private enterprise in the endeavor to prevent abuses, to protect the general public and to achieve certain economic objectives. They have therefore imposed economic controls of various types, and in order to obtain the increasing amount of money needed to carry on the expanding activities of government have raised taxes. In most countries governments have gone a considerable distance in the extension of government regulations and participation in economic activities. The problem of seeking a proper balance between the advantages of particular regulations or activities, and the harm that may result to industry and the public have at times received inadequate attention. Investors do not wish to enter a country where their operations would be seriously hampered by government regulations, especially regulations which to the investors appear unwarranted and burdensome. Regardless of the needs or merits of particular regulations, if they become burdensome to the conduct of an enterprise, foreign investors prefer countries where regulations are less restrictive.

4. *Nationalism and antiforeign feeling resulting in actual or threatened discrimination:* Some countries have strong national feelings against foreign control of undertakings within their borders. This feeling has led in a number of countries, even where nationalism is not particularly strong, to the adoption of laws which require that a certain percentage of the workers, or perhaps of the owners, be nationals.

Some countries fear foreign exploitation contrary to the national interest, or for various other reasons do not desire to see foreigners in substantial control on any large scale of enterprise in their country. These fears may rest upon unfortunate experiences in the past with respect to foreign companies in their country or elsewhere. Such countries probably do not realize that the practices and abuses which they fear and which were not uncommon a generation or two ago are today largely no longer present. The large corporations today for the most

part endeavor to obtain local good-will and to conform to or improve upon local standards with respect to treatment of workers and other matters. Nevertheless, it is understandable that a small foreign country does not wish to have foreigners own and operate a large segment of its productive undertakings. The country may therefore require that a new foreign-owned undertaking obtain official approval before being admitted to the country, and be subject to a number of special regulations.

Discriminatory treatment, which may result from the above attitude, of foreign enterprises operating in a country is not conducive to the receipt of additional investment. Similarly an unfriendly or suspicious attitude toward foreign enterprises, particularly if this is widespread in the press and with the general public, will discourage new investment. Such an attitude exists in a number of countries although it appears to be declining. Where it exists it is usually based to a large extent on ignorance of the benefits and present character of foreign investment. It is possible to impose safeguards which are needed against possible abuses of foreign investors without driving away new foreign capital.

5. *Inability freely to transfer earnings and withdraw capital, or the threat of such inability:* The widespread use of exchange restrictions which interfere with the free transfer of funds out of a country is an important deterrent to potential investors, since investors wish ultimately to receive dollars rather than a local foreign currency. The lack of free convertibility of currencies has on many occasions prevented investors from transferring funds as they desired. It has caused them to be reluctant to expand their investments, and has discouraged potential new investors.

6. *Unfamiliarity of investors with foreign investment:* Potential investors frequently have little information or experience with respect to foreign investment or foreign countries. Investing at home is much easier. Foreign investment to them seems strange and full of pitfalls; the unknown appears dangerous. Efforts have been made to acquaint investors with foreign opportunities, but the educational process is necessarily slow.

The lack of a substantial outflow of American private investment capital, together with the importance to foreign countries and to the United States of such an outflow, raises important questions regarding the role of government in foreign capital investment. These subjects are discussed in following chapters.

Chapter 28

UNITED STATES FOREIGN INVESTMENT POLICY

Open-Door Policy; Screening New Foreign Investments. —United States foreign investment policy is an integral part of this country's foreign economic policy as discussed in Chapter 34. Consistent with United States views on international trade, foreign exchange and economic relations generally, the United States believes that investors should enjoy reasonable freedom in undertaking investments in any part of the world. The United States has thus adhered to and urged acceptance of the historic open-door policy. According to this policy a country should provide equal opportunity to the citizens of all nations for trade and investment within its territories. The policy is that of nondiscrimination and the absence of "spheres of influence," of areas closed to all but nationals of a favored country, and of exclusive concessions or other special privileges, except where necessary by the nature of the undertaking.

About the first of this century the United States found itself insisting upon the open door with respect to China since certain European nations were endeavoring to secure special political and economic privileges there. In 1899 the United States finally persuaded the European powers and Japan to accept the open-door policy. The firm position taken by the United States at that time, under the leadership of Secretary of State John Hay, was to a large extent responsible for maintenance of the territorial integrity of China. As a result of the Washington Conference of 1921-22, the open-door policy was for the first time embodied in a formal treaty. In 1931 and 1932, when Japan created the puppet state of Manchukuo and closed this area

largely to the trade and investment of other than Japanese nationals, the United States protested vigorously. The United States, however, did not care to back its views with force, in accordance with the policy enunciated by Secretary of State John Hay in 1901 when he said that this country was not prepared to enforce its views with respect to the Orient by a demonstration hostile to any other power.

Akin to the question of nondiscrimination as between foreign nationals is that of whether a country, so long as it treats all foreigners alike, can close the door partly or even entirely to investors of all foreign countries. On this subject the open-door policy is usually interpreted to mean that the door must in fact be open, at least to a reasonable extent, as well as that it must be open equally to all nations. The United States advocates a liberal open-door policy, but does not interpret the policy as involving a right of foreigners for full or even partial entry. The United States does not deny the sovereign right of a country to determine its own policy with respect to the admission of foreign investment, even to the extent of shutting out foreign investment completely or on a discriminatory basis. The United States, however, may disagree with a country as to the wisdom and equity of restrictive actions, and may urge a more liberal policy.

Most nations, including the United States, have for many years forbidden foreign nationals to engage in certain types of undertakings, so that the door is almost never completely open, even though it may be open equally to all foreigners. In recent years, accompanying the tendency toward an expansion of the regulatory functions of government, a number of countries have desired to control in some detail the entry of new investment capital.[1] The purpose is to screen new investments individually from the standpoint of the contribution such investments may make to the country's economic development, and also from the standpoint of the prospective effect of such investment on the economy in general, particularly the balance of payments. A country, for example, may discourage new foreign investment in

[1] Control over capital movements, particularly capital exports, for the purpose of protecting monetary reserves is a separate matter.

a luxury or nonessential industry. It also may fear domination by foreign capital and therefore seek to limit such investment, or it may desire to reserve certain fields for local producers and to shut out foreign competition similarly as it does by tariffs. Countries which desire to screen new investments are ordinarily those in which nationalism is strong and where foreign competition is feared.

Screening the entry of new investment is not necessarily inconsistent with a policy of relative freedom for such investment. If entry requirements and procedures are liberal, and are administered in a reasonable and nondiscriminatory manner, the door is effectively open even though not completely open. A completely open door, in any event, seldom exists. On the other hand, if screening involves extensive denials and is administered on a basis of favoritism to certain countries or groups, and as a means of capricious or arbitrary discrimination, it is clearly in contravention to a policy of relative freedom. If an investor is not allowed to enter until after first obtaining a ticket of admission, the substance of the question is how difficult it is to obtain such a ticket and on what basis tickets are made available. The nature of entry requirements and the kind of administration which is applied to screening, therefore, determine whether relative freedom of foreign investment in effect exists or not.

Treatment of Foreign Investments.—The United States believes that investors who have been allowed to enter a country should be accorded national treatment once they are there, with certain exceptions. They and their property should thus in general be treated as favorably as a country's own nationals and such national's property in like situations. The United States conforms to this policy in its treatment of aliens and their property. In cases where national treatment is not accorded by foreign countries to aliens, such as in certain sensitive fields reserved to a country's own nationals for security or other reasons, the United States seeks most-favored-nation treatment for United States nationals. The United States believes that the treatment accorded United States nationals should in any event

be fair and equitable, and does not consider as adequate national treatment which departs from recognized standards of equity. This view is in accord with this country's interpretation of international law that certain minimum standards of treatment are required.

Until recently the nationals of some of the leading powers enjoyed what are known as extraterritorial rights in certain parts of the world, notably in China, the Near East, and Africa, where local laws and the protection of persons and property were considered inadequate. Extraterritoriality, established by treaty, provided that nationals of the treaty powers were not subject to the jurisdiction of the local authorities, local laws, and regulations. Foreign investors and traders were therefore subject only to their own government, and enjoyed usually better treatment than that accorded local nationals. The foreign governments established consular courts in such territories, and made other provisions for administering affairs there which involved their own nationals. Extraterritoriality is obviously offensive to the foreign country and inconsistent with national aspirations and dignity. It has been abandoned in all parts of the world except in Morocco by the United States, where a special situation exists and where continuation of extraterritoriality is temporarily desired by Morocco in view of the protectorate status of Morocco.

The United States seeks recognition of the above policies regarding the open door and the treatment accorded its nationals in formal treaties, as discussed in Chapter 31. It also endeavors to protect the rights of United States nationals in other ways insofar as it appropriately can. When United States investors encounter difficulties with a foreign government or national, or are subjected to unreasonable action, and are not able to obtain adequate consideration through established channels, the United States Government is prepared to use its good offices or take other appropriate diplomatic action in behalf of the United States national as the circumstances warrant. When, for example, foreign governments take possession of properties of United States nationals and do not pay adequate compensation, the United States endeavors to obtain an equitable settlement, provided the investors have exhausted local remedies and provided the cir-

cumstances warrant United States Government interest in the problem.

Use of Force to Protect Investments.—The United States has never believed that military intervention should be used in behalf of investors, a practice formerly followed by the leading European powers. Formerly, the United States in order to forestall European intervention occasionally landed troops in Latin America when conditions there became disturbed. The protection of property was incidental to a broader purpose, which had to do with the maintenance of the Monroe Doctrine as discussed in Chapter 36. This practice, which was open to difficulties and misinterpretation, was abandoned by the United States during the 1920's. The United States may urge its citizens to leave areas where disturbances threaten and assist them in departing.

Until about 1907 most of the leading governments accepted the idea that military means might properly be used, if necessary, to enforce the collection of debts from defaulting foreign states. Thus, in Great Britain Lord Palmerston declared in 1848 that governments were entitled to demand redress from a foreign state for the legitimate complaints of their subjects, and that when such states had failed to meet their obligations the British Government was prepared, in certain circumstances, to use force. This policy was accepted by Lord Salisbury in 1880.

In 1902 Venezuela had defaulted in its external loans, and was pressed by European powers for a settlement. Failing to obtain this, Great Britain, Germany, and Italy sent their fleets to Venezuela and blockaded the country's ports. German ships bombarded Puerto Cabello. When the use of force against Venezuela was first contemplated President Theodore Roosevelt had said that this government would not guarantee a state against punishment if it misconducted itself, provided that punishment did not involve acquisition of territory by a non-American power. Later, however, when the European nations moved against Venezuela, President Roosevelt protested vigorously. As a result arbitration took place. The event caused Dr. Drago, the foreign minister of Argentina, to declare the

principle in a letter to the Argentine minister in Washington, that "a public debt cannot give rise to the right of intervention, and much less to the occupation of the soil of any American nation by any European power."[2] This proposal was supported by the United States, but was not generally accepted by other countries at that time.

At the Second Hague Conference, in 1907, an agreement was entered into, named after the United States delegate, General Porter, who introduced and defended it, which provided that the contracting parties would not "have recourse to armed force for the recovery of contract debts claimed from the Government of one country by the Government of another country as being due its nationals."[3] This agreement, however, was not to apply if the debtor country refused to arbitrate, or, having accepted arbitration, failed to carry out the award. In the eyes of Latin Americans the matter was therefore not entirely satisfactory. The United States was unwilling to deny the right of intervention if a country rejected compulsory arbitration. Finally at the Montevideo conference in 1933 the United States accepted the general principle that no state could intervene in the affairs of another.[4]

Calvo Doctrine.—Several Latin-American countries take the position that a foreign investor is completely subject to the laws and regulations of the country in which the investment is situated, and under no circumstances does his government have the right to intervene diplomatically in behalf of his interests. This position is the essence of the so-called Calvo doctrine advanced by Carlos Calvo, an Argentine jurist who wrote in 1868. The Calvo doctrine contends that since a sovereign state is free and independent it enjoys the right to freedom from interference of any sort from other states. Therefore aliens are not entitled to rights and privileges not accorded to nationals, and may not seek redress for grievances except from local authorities.[5]

[2] Charles G. Fenwick, *International Law* (New York: Appleton-Century-Crofts, Inc., 1926).

[3] *Ibid.*

[4] Cf. page 637.

[5] Cf. Green H. Hackworth, *Digest of International Law* (Washington, D. C.: United States Government Printing Office, 1943), V, 635.

Frequently the so-called Calvo clause is inserted in contracts between an alien and a Latin-American government to the effect that the alien will not seek the diplomatic intervention of his government with respect to any differences that may arise under the contract, but will rely exclusively upon local remedies. In some cases the clause does not deny the right of diplomatic intervention after local remedies have been exhausted.

The United States does not subscribe to the Calvo doctrine, which it considers contrary to international law, nor recognize the validity of the Calvo clause in contracts. The United States holds that an individual may not waive the right and privilege of his government to protect its citizens abroad, according to a statement prepared by the State Department and sent by the President to the Senate in 1908. The Calvo doctrine has been the subject of debate between the United States and Latin-American governments, particularly in connection with the proposed charter of the International Trade Organization, and the Bogota Economic Agreement, discussed elsewhere. Inclusion in the ITO charter of clauses slanted in the direction of the Calvo doctrine (Article 12), and in the case of the Bogota Agreement of several reservations recognizing the Calvo doctrine were important factors in the nonacceptance by United States of both of these documents.

Former Bans on Foreign Lending.—Congress in 1934 passed the so-called Johnson Act, which made it a criminal offense to lend money to a government which was in default on obligations owing to the United States Government. The Act was aimed particularly at the first World War debts in default to the United States Government. A further restriction on foreign lending was imposed by the neutrality legislation of 1936 and 1937. Lending to nations at war was thought to lead to military involvement of the lender, so the 1936 amendments to the neutrality law of 1935 imposed a ban on all loans to belligerents.

The Neutrality Act of 1937, superseding that of 1935, aimed to shut America off as completely as possible from the kind of trade and financial dealings with belligerents which were thought

might involve this country in hostilities. The Act directed the President, when he found a "state of war" existed between two or more powers, to issue a proclamation to that effect, which automatically prohibited certain trade and financial transactions with belligerents. The President had considerable latitude in determining whether a state of war existed, and in 1937 when Japan invaded China he did not declare that a state of war existed. Neither Japan nor China desired such a declaration.

These prohibitions were based largely on the thought that United States entry into the previous war was due to loans extended to the Allied Powers. They were the product of the isolationist sentiment which dominated the country's thinking at that time. They also represented public dissatisfaction over the attitude of European nations toward their debts owing to the United States Government.

The Neutrality Act, instead of contributing to peace, had the opposite effect. It was an invitation to aggression and was in effect an announcement to aggressors that the United States would keep "hands off." These measures, especially the so-called "cash and carry" provisions which banned the extension of credits for certain transactions, interfered with the ability of Great Britain to obtain needed supplies in the United States during the first part of the war. The adoption of the Lend-Lease Act in March, 1941, relieved the situation and resulted in the provision of large amounts of military and other supplies to nations opposing Germany and Italy. The Neutrality Act was not repealed, but was emasculated by the Lend-Lease Act, and by an amendment in November, 1941, so that the effect was similar to repeal. The Johnson Act also was not repealed, but in 1945 was made inapplicable to members of the International Monetary Fund and Bank.

The Government and New Foreign Investments.—The United States desires to encourage the flow of private foreign investment for productive purposes in view of the mutual advantages to the United States and the recipient country and the contribution such investment can make to economic development and to the expansion of trade and production generally.

Foreign investment is considered by the United States an important adjunct to the technical assistance program discussed in Chapter 30. It can greatly increase the benefits to be derived from this program inasmuch as the combination of capital and skill is an effective means to economic development.

The United States Government has, since the war, sought by various means to facilitate an increase of foreign investment. The United States has concluded treaties, and is negotiating others, which provide assurances to investors regarding their rights in foreign countries and the treatment they shall be accorded there, as described in Chapter 31. It also aids investors by providing them with information and by rendering whatever assistance it can appropriately extend in the field through United States embassies, legations, and consulates. The United States does not, however, desire to encourage investment for projects which are not economically suited to the area and which will require tariffs or subsidies in order to survive. The United States Executive sought from Congress in 1950 authority to guarantee certain new foreign investments against inability to transfer earnings, and against expropriation without adequate compensation. The proposal did not involve any guarantee of a profit, but merely insurance against certain hazards peculiar to foreign investment.

In spite of the various efforts of the government, private investment has not shown signs of much recovery apart from special instances such as oil investments in Latin America and the Middle East by large oil companies. The lack of new private investment, if this is to continue, raises questions regarding the extent to which the government should fill the void through government loans. This subject is discussed in Chapter 30 on economic development.

The United States believes that foreign investment should, insofar as feasible, provide opportunity for the participation of capital and management of the country where the investment takes place.[6] Such participation, however, should be on a volun-

[6] The United States concurred in a resolution to this effect adopted by the Inter-American Conference on Problems of War and Peace held in Mexico City in 1945.

tary basis, and not be embodied in legislation which requires local participation. Requirements of this nature tend to discourage new foreign investment and to destroy the effective cooperation resulting from voluntary association.

The United States Government desires that investors keep it informed of their plans for substantial new investments in foreign countries. Shortly after the first World War the government felt it desirable to exercise some control over new foreign investments in view of their effects upon this country's national interests. After an informal understanding that investment bankers consult the State Department regarding contemplated transactions was not always observed, the State Department in 1922 issued an announcement that all underwriters of foreign bonds sold to the United States public should first obtain in writing the attitude of the State Department. Underwriters complied with this request; it would have been difficult otherwise for them to have disposed of an issue, and also they might on occasion need the support of their government. The State Department avoided giving specific approval to a contemplated loan, but would reply negatively to the effect that it did not wish to object, namely, "The Department, in the light of the information at hand, offers no objection to the proposed transaction." If the Department was dissatisfied it would reply, "The Department is unable to view the proposed financing with favor at this time." When the Department's policy of reviewing loans was later criticized the "no objection" statement was changed, in 1929, to "The Department is not interested."

The Department in considering foreign loans looked particularly for features which might have undesirable international political repercussions, such as excessively burdensome terms, or features which were inconsistent with this country's foreign policy. Secretary of State Hughes said, "I am disposed to discountenance loans to unrecognized governments, or loans sought by foreign governments for military purposes or for objects that appear to run counter to clearly defined policies of this government." [7] The Department endeavored, among

[7] *Foreign Relations of the United States, 1922,* II, 764-66.

other things, to protect foreign countries against onerous terms and conditions, corruption, or exploitation by American investors. It prevented loans to Honduras and Guatemala for these reasons. In the case of Guatemala the bankers would have obtained control over Guatemalan currency and exchange for 27 years. Some of the undesirable purposes commonly considered by the Department in objecting to loans were: the meeting of budgetary deficits, financing military expenditures, assistance to monopolies harmful to Americans, aid to governments not recognized by the United States, and aid to governments or citizens in countries in default to the United States Government.

The State Department made it clear that if it failed to object to a loan, such lack of objection was not to be construed as approval or as a judgment on the soundness of the loan. Nevertheless, promoters sometimes sought to imply that the Department had endorsed the issue. The period of reckless foreign lending, during which time the Department's policy was in operation, was followed by a day of reckoning. When a number of foreign issues went into default during the depression of the 1930's and when dissatisfaction was widespread, the Department's policy did not escape criticism. The Department pointed out that it had never taken responsibility for the soundness of the loans, and had, in fact, specifically announced this at the time. The lack of new foreign issues in recent years has caused the question of government review of public issues to be of no great general interest.[8]

The government at the present time desires to be kept informed regarding contemplated foreign investments of substantial size, of whatever type, in view of the close relationship between such investment and international political and economic affairs. The government may propose elimination of certain features harmful to the best interests of this country or of the foreign country, such as terms or conditions likely to become the subject of reasonable public resentment in either country, or which are otherwise detrimental to good relations between the

[8] For a discussion of this period and the problems see Herbert Feis, *The Diplomacy of the Dollar* (Baltimore: The Johns Hopkins Press, 1950).

United States and a foreign country. Only rarely, however, is there need for suggesting changes in features of proposed investments, and the role of the government is, in fact, largely that of facilitating the investment. The Department of State, Department of Commerce, and Securities and Exchange Commission are the government agencies especially interested in foreign investment matters.

Chapter 29

THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

Background of Plan for International Bank.—The flow of United States investment capital into foreign countries declined drastically beginning about 1930, following several years of extensive and at times ill-considered lending, as already discussed. The defaults and losses to investors during the depression of the 1930's on the large amount of dollar bonds of foreign governments, which had been sold widely to the United States public, caused the pendulum to swing in the opposite direction, and foreign lending dwindled to an almost negligible amount. The investing public came to look with disfavor on all foreign obligations; and at the same time foreign countries, burdened with debt, did not desire to borrow abroad. Foreign investment was also discouraged by balance of payments disturbances and the consequent difficulty of transferring funds, as well as by international political uncertainties. The drying up of United States foreign investment applied not only to loans but also to direct investments. Most of the United States capital going into foreign countries during the 1920's, had gone in the form of loans rather than as direct investments, so that the shrinkage in the latter was not as great.

The aloofness of United States investors to the foreign field continued into the postwar period, particularly since profits on domestic investments were good, and attractive opportunities existed for investment at home. While the isolationist approach to investing was less pronounced after the war, the conditions of international uncertainty and disturbance continued to discourage foreign investment. Furthermore, investors were frightened by the trend in most countries toward increasing government

regulation of economic affairs, involving in some cases nationalization of industries and the imposition of burdensome regulations, as noted previously. In certain countries strong nationalism and an antiforeign feeling contributed to the unwillingness of United States investors to risk their funds abroad.

The United States, with its large national income and volume of savings was the principal potential source of foreign capital for most of the world after the war. While United States private capital was not flowing in sizable amounts into foreign countries, except in a few instances such as for petroleum development, the needs of foreign countries for such capital were great. The devastation of the war created an urgent demand for funds to aid in reconstruction. The countries of Europe and the Far East required aid in rebuilding their cities, harbors, transportation, and other facilities. They also had an immediate need for food and other essential commodities.

The postwar needs for funds for relief purposes are to be distinguished from the needs for capital for reconstruction. Relief funds, it is generally assumed, should ordinarily be supplied in the form of grants rather than as loans, which are more appropriate for financing long-term revenue-producing undertakings. In many respects, however, the two uses of funds overlap. A government, for example, may use its borrowing capacity to obtain funds for relief, or, on the other hand, goods bought with funds donated for relief purposes may be utilized to aid reconstruction, such as when the goods are sold and the local currency received used for reconstruction projects, such as the rebuilding of a hydroelectric plant.

In addition to needs for capital for reconstruction, the postwar period witnessed a widespread and strong demand on the part of countries with low standards of living for funds for economic development. The underdeveloped countries have become aroused over the contrast between their conditions and those of the advanced countries. The tools and productive equipment in a large part of the world are primitive and meager, particularly in contrast with productive facilities in the United States and other countries. Large amounts of capital are needed, both foreign and local, to expand output and to improve

the level of production and consumption generally throughout a large part of the world. Some of the purposes for which capital is needed, such as for health, education, highway construction, etc., are of a nonrevenue producing nature in the immediate sense. Other projects, such as electric power development, the importation of agricultural machinery, etc., provide revenue which can service a loan. This latter type of project is generally considered more appropriate for investment capital than the nonrevenue producing types.

The above needs for funds were anticipated while the war was still in progress, and plans were made to meet them. According to these plans, funds for relief were supplied as grants by the United States and other nations through the United Nations Relief and Rehabilitation Administration (UNRRA).

As regards capital for reconstruction and development, it was seen that private capital would not be forthcoming in adequate amounts, and that government funds would be required. The magnitude of the task, however, was not foreseen. Nor was it realized that much of the money needed for reconstruction would have to be provided on a grant rather than on a loan basis. The Marshall Plan was thus later developed by the United States to meet this unanticipated need for large sums to aid reconstruction. It provided most of these funds on a grant basis.

Formulation of Bank Proposal.—The plans which were made for postwar reconstruction and development involved the establishment of an intergovernmental lending institution or bank. It was believed desirable that the risks of lending should not be assumed by the United States alone, but be spread among nations on the basis of their resources. It was also recognized that underdeveloped countries would prefer that money be made available under international auspices so as to assure them that a loan was free from political or interventionist implications. The institution proposed was to be complementary to the International Monetary Fund. The resources of the Fund were not to be available for capital investment or long-term transactions, but were to be for the purpose of helping a country meet short-term balance of payments deficits. They could thus not appro-

priately be used to finance reconstruction or development projects. An international bank was planned to provide investment capital that would not be available through ordinary business channels.

An intergovernmental lending institution involved a departure from former accepted principles of investment. The private capital market had generally been considered the best judge of the financial soundness of a borrower, and fears were expressed that the proposed bank would make loans that were not financially sound, even though the bank was supposed to make only loans that had reasonable prospects of repayment. On the other hand, it was pointed out that the bank could assume risks that were too large or inappropriate for private capital. For example, a large project like Boulder Dam is not well suited to private financing. While a project may be too risky to attract private capital, it may nonetheless not involve excessive hazards for a large bank able to absorb occasional losses and to wait until conditions improve in the event of financial difficulties. Furthermore, the project may be in the public interest, and the desirability of a particular foreign investment, or of foreign investments in general, from the standpoint of the public cannot be judged by business standards of profit and loss. Individual investors cannot be expected to be extensively concerned with matters beyond those of a profit nature.

A problem for a government lending institution that intends to remain solvent is to reconcile the avoidance of undue risks with the financing of projects which are in the public interest. It must serve the public interest and at the same time not assume unreasonable risks. The public interest may indicate the extension of loans for nonrevenue producing development projects, helping to maintain employment and stable economic conditions, or for special purposes such as assisting a government after an earthquake or other catastrophe. If the bank, however, is to make loans for such purposes, it must assure itself of the borrower's ability to repay. It was believed that a large field existed where sound loans were possible for an intergovernmental lending institution, loans which would not be made by private capital.

Plans for the International Bank for Reconstruction and Development, the name chosen for the proposed institution, were formulated more or less simultaneously with those for the International Monetary Fund. At one stage it was debated whether the two institutions should not be combined into one. This idea was discarded since their functions are distinct and, it was believed, could better be performed by two separate but closely associated institutions. The discussions among United States and other technical experts in planning these institutions centered largely on the proposed Fund, and not until a few weeks before the Bretton Woods Conference, when the British experts made constructive suggestions regarding the Bank's structure, was it clear that the Bank proposal would receive major consideration and be likely to be adopted. The United States interest in these institutions during the pre-Bretton Woods period was largely in the Fund, an agency to help stabilize exchange rates, whereas the principal interest of most of the foreign countries was in the Bank, an institution which could supply them with needed funds for reconstruction and development.

The discussions which led to the formulation of the Bank and Fund proposals, and the Bretton Woods Conference which met in July, 1944, have already been described in Chapter 25. An account of these discussions and the Conference need not be repeated here. The Articles of Agreement for the Bank were signed, along with those for the Fund, December 27, 1945, by thirty countries and later by others. The World Bank, as it has come to be known, thereupon came into legal existence, although it was not until some months later that the Bank was actually organized and operations were begun.

Nature of World Bank.—The purposes of the Bank are set forth in Article I of the Articles of Agreement, and indicate its general nature. These purposes include the following:

1. To assist in the reconstruction and development of territories of members. . . .

2. To promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supple-

ment private investment by providing, on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources.

The loans of the Bank must be exclusively for the benefit of its members and are to be made with "due regard to the prospects that the borrower . . . will be in position to meet its obligations under the loan." The Bank is thus not allowed to make grants or loans that approximate grants, but is to confine its loans to those which it believes will be repaid. Repayments thus provide money for new loans. The Bank may make loans to private borrowers, but all loans must be guaranteed by a member government. The Bank is not to compete with private capital and may not make a loan if private capital is available on reasonable terms.

Loans must ordinarily be for specific projects rather than for general purposes of the borrower. This provision helps to assure that the Bank's funds are used for productive purposes. The Bank keeps in touch with projects under construction and makes the money available as it is needed. The Bank provides funds needed to cover payments for imported goods and services, although in exceptional circumstances the Bank may lend money to cover expenditures in local currency. The intention is that a borrower should not look to the Bank for local currency needs, but should borrow from the Bank only to meet foreign exchange costs. The reasoning behind this provision is that local expenses should ordinarily be met from local sources, so as not to burden the country with obligations payable in foreign currency, and also so as not to contribute to local inflation. For example, if the Bank were to loan dollars and these dollars were exchanged for local currency the effect might be to expand the country's monetary reserves and local money supply. If the project stimulates local activity and leads indirectly to enlarged imports, the Bank may provide foreign exchange to meet these needs. The practical application of this authority, however, is difficult.

The Bank ordinarily lends a borrower the particular kind of currency needed to pay for the foreign goods required by the

project. The loans, however, are not ordinarily "tied loans" in the strict sense, and dollars, for example, loaned to a borrower are often converted into other currencies which are expended outside of the United States. The currencies which the borrower is obligated to repay are determined by the kinds of currencies which the Bank disburses to meet the borrower's needs. The borrower ordinarily must repay the same currencies borrowed, which are to equal the gold value of such currencies at the time the loan was made. The Articles of Agreement provide (Article IV, section 4) as follows:

> These payments (interest, amortization, etc.) ... shall be equivalent to the value of such contractual payments at the time the loans were made, in terms of a currency specified for the purpose by the Bank by a three fourths majority of the total voting power.

The Bank has an authorized capital of $10 billion of which $8.363 billion has been subscribed by the present forty-nine members on the basis of assigned quotas. The United States subscription is $3.175 billion. Only 20 per cent of the subscribed capital, however, is paid in and available for loans by the Bank. The remainder is a guarantee fund which can be called for payment only if needed in connection with the Bank's guarantees or other obligations. Two per cent of a member's subscription is payable in gold or United States dollars and the balance in its own currency. In order to obtain additional funds for lending the Bank may sell its own obligations in the private capital market. Such sale was intended to be the principal source of funds for the Bank, and will probably eventually be such.

In order to be a member of the Bank a country must first be a member of the Fund. The two institutions thus have identical membership, consisting of forty-nine countries in July, 1951. The Bank like the Fund, is governed by a Board of fourteen Executive Directors (there must be at least twelve), which is in continuous session at the Bank's headquarters. The Board of Governors, consisting of one governor and one alternate appointed by each member, is the final authority and meets annually, usually in Washington, which is the Bank's head-

quarters. Voting on both boards is weighted according to the size of a member's subscription. The U.S.S.R. is not a member of either institution.

The Bank in Operation.—The Board of Directors of the Bank held its first meeting in May, 1946, and in June the Bank called for the first payment on the subscriptions to its stock, followed shortly thereafter by other calls until the full 20 per cent that could be called for payment had been called.

One of the first tasks which confronted the Bank was that of establishing standards for the making of loans. Inasmuch as the Bank planned to borrow money through the sale of its own bonds in the capital market (so as to obtain additional funds to lend abroad), it needed to build a reputation which would make its bonds readily marketable and at low rates of interest. It believed, therefore, that it should be cautious in its loan policies and establish a solid reputation.

The Bank made its first loan in May, 1947, a loan to France in the amount of $250 million for reconstruction purposes. This was followed in August of the same year by a loan of $195 million to the Netherlands for similar purposes. A few other loans were made during the next year or two, but the Bank's policy was to move slowly, desiring to build well. The loans during the early period were all to European countries and for reconstruction purposes. Some dissatisfaction among members was expressed at what was considered the small volume of loans. The Latin-American and other non-European countries were also critical that the emphasis was exclusively on reconstruction loans. They felt that the Bank was not interested in development loans and was partial to the countries of Europe. The Latin-American countries accordingly urged the establishment of an Inter-American Bank, reviving an older proposal.

In March, 1948, the Bank made a loan to Chile followed in 1949 by loans to Mexico, Brazil, and later to other Latin-American countries. By July, 1951, it had made loans to India, Australia, Ethiopia, and countries in various other parts of the world, in all to twenty-two of its forty-nine members. The Bank had become in a real sense a world bank, although the money

loaned was still almost wholly United States dollars. Its total loans outstanding in June, 1951, amounted to $1.106 billion. The Bank considered its reconstruction responsibilities largely completed and concentrated on promoting economic development. Criticism of geographic bias had disappeared. The Bank was generally well regarded by its members, by investors, and the general public, although certain underdeveloped countries were pressing for a more liberal loan policy.

The Bank makes careful investigations before a loan is granted, and has in the field most of the time missions making economic and engineering studies in connection with possible projects. It investigates the over-all economic and financial position of the borrower as well as the feasibility and merits of the individual project. A limiting factor which frequently prevents a loan is inadequate planning and technical data supplied by the applying borrower regarding a project. The Bank in its desire to avoid mistakes sets high standards and requires complete and reliable information before extending a loan. Insofar as possible the Bank helps a member develop this information.

The demands upon the Bank by borrowers have been largely for United States dollars. In order to obtain additional dollars to lend, the Bank in 1947 sold $250 million of its own bonds. It went to the American capital market again in 1950 and also in 1951. It also has sold obligations in Swiss francs to the equivalent of about $10 million, and in May, 1951, made a public offering in London of £5,000,000 of its 20-year bonds. Its funds available for lending were also increased as several countries authorized the lending of their currencies which had been paid into the Bank by them on their subscriptions.[1]

The Bank has sold to private buyers some of the bonds from its investment portfolio. These bonds represented loans previously made by the Bank. Some of these bonds sold by the Bank were sold with the Bank's guarantee and some were sold without recourse.

[1] According to the Articles of Agreement, of the 20 per cent of subscriptions paid in (2 per cent is payable in gold or in United States dollars), the 18 per cent paid in the members' own currency is loanable only with the approval of the members.

The Bank's interest charges to borrowers are low, especially in comparison with rates prevailing in most countries. The rates are uniform to all classes of borrowers, although variations occur with the length of the period for which the money is borrowed, and due to variations in the cost of the money to the Bank. The Bank's charges are based upon the cost of the money to the Bank and include a commission of 1 per cent per annum as required by the Articles of Agreement. The combined interest and commission charges are illustrated by the following examples: 3¾ per cent on a fifteen-year loan, 4 per cent on a twenty-year loan, and 4¼ per cent on a twenty-five-year loan.

In view of the Bank's large resources, a little over $2 billion in 1951, the Bank's earnings are much more than needed to pay its operating expenses. By June, 1951, the Bank had made net profits totaling approximately $40 million. It had also built up substantial reserve funds.

The Bank has not made very many loans to private borrowers inasmuch as, according to the Articles of Agreement, these must be guaranteed by a member government, and governments are usually reluctant to guarantee loans to private enterprises. Private borrowers also do not welcome a government guarantee, since they fear it may lead to government participation in the control and management of the enterprise. The Bank would like to expand its private loans but is confronted with these difficulties.

In order to facilitate economic development the Bank extends various types of technical assistance to its members. It sends missions, at the request of a member, to make general surveys of the country's economic and financial problems and the lines along which economic development might appropriately proceed. It also makes recommendations regarding specific problems. The technical assistance phase of the Bank's activities has been expanding and becoming increasingly important. It is welcomed by members.

Suggestions have been made that in the event of a decline in business activity very large sums of capital should be invested for economic development in order to check the depression, and at the same time to accomplish this objective in a manner yield-

ing constructive results. It is held that the International Bank should be prepared to advance, if there were a depression, unusually large sums of money and that it might, for example, set up a special department supplied with funds which could be advanced on a basis not limited by rigid standards of repayment. The proposals envisage an area between grants on the one hand and sound loans on the other hand, wherein funds can advantageously be expended in periods of unemployment and depression.

In addition to the proposed use of international investment funds to promote economic stability, it has been suggested that, except in the rare periods of full utilization of resources, large sums can usefully be invested for their multiplier effects upon the incomes of the investing country as well as their benefits to the underdeveloped areas. In reviewing British foreign investment experience Lord Keynes once remarked that inasmuch as Great Britain had continually reinvested abroad the earnings from her foreign investments, she had little to show directly from such investments except pieces of paper or book entries of foreign assets. The benefits to the British economy and to the world, he said, had nevertheless been great. These investments, he added, also helped Britain to finance two wars.[2]

This line of reasoning and the implications for International Bank policies raise a number of difficult questions. The Bank, according to its Articles of Agreement, must have strict regard to prospects of repayment. Furthermore, if the Bank is to continue in operation and to have funds from repaid loans which it can again lend, and if it is to be able to borrow money in the market to increase its lending resources, it must confine its loans to those that appear likely to be repaid. Apart from economic considerations and the merits of the proposals, the Bank as presently constituted could not go far in implementing the policies suggested. Such policies would require a substantial alteration of the Bank's nature as originally contemplated and as embodied in its basic charter. A different type of institution would be needed for such purposes.

[2] See Chapters 9 and 16.

The Bank has made good progress in the few years of its existence, is a well-established and well-regarded going concern, and in its present form is effectively helping to meet important needs. The Bank is making a noteworthy contribution to the economic development of underdeveloped countries and is also of assistance to the more advanced countries.

Chapter 30

ECONOMIC DEVELOPMENT—THE UNITED STATES TECHNICAL COOPERATION PROGRAM, "POINT FOUR"

Growth of Interest in Economic Development.—In recent years economic development has become a major objective of national policy in practically all of the underdeveloped countries of the world. Peoples in these areas have become aroused over the backward conditions under which they live, wherein elementary necessities are frequently lacking to large masses of people. They have become increasingly aware of their low standards of living, of the contrasts with conditions in the advanced countries, and of the possibilities for their own advancement. The peoples of underdeveloped areas are restless and determined to improve their lot, to reduce illiteracy, improve health, and sanitation, and to raise the level of their incomes and economic life in general. They will no longer tolerate prevailing conditions and are pressing for aid to solve their problems. In international gatherings, particularly at the United Nations Economic and Social Council, and wherever opportunity permits, representatives of the underdeveloped countries urge attention for their needs. The United Nations has established an Economic, Employment and Development Commission which is giving detailed study to the problem.[1]

Demands for development have become mixed with politics, and in colonial and other dependent areas with aspirations for political independence. Dissatisfaction and impatience for more rapid progress have led to misguided and confused efforts, to political difficulties and to violence. The unfortunate condition

[1] The word "Development" was added to the title of the former Economic and Employment Commission.

of the underdeveloped peoples has been seized upon by Communists and others to advance their own interests. Promises have attracted masses of people who are unable to determine whether the promises are likely to be fulfilled. Peoples living under conditions of extreme poverty and with little knowledge of the world outside of their immediate surroundings are not able to appraise the most suitable means for the advancement of their economy. The problem of methods and their relative merits is submerged under the pressing needs of the moment and political maneuvering. Underdeveloped areas are thus fertile ground for ideologies which offer something new; any change from the present seems good.

The problem of development offers a challenge to the advanced countries, both on humanitarian grounds and on those of self-interest. The self-interest has to do with the protection of democratic and free institutions. An effective answer to communism is a positive and vigorous program of aid adequate to the needs, but the implementation of such a program is not a simple process. An appropriation of funds for economic development is merely a beginning, as noted below. Education and major social changes are ordinarily required along with physical development.

Economic development, in addition to supporting free institutions, also provides benefits to the advanced countries resulting from an expanded interchange of goods and services. As the purchasing power of underdeveloped areas increases, they import more from the advanced countries. Prior to the second World War the exports of the United States to the underdeveloped countries amounted to only seventy cents per person, whereas United States exports to the advanced countries were $5.80 per person. The advanced countries can well afford to facilitate development of the underdeveloped areas on purely commercial grounds. The underdeveloped countries are also important sources of raw materials needed by the advanced countries. More important, however, is the humanitarian basis and the fact that the restlessness, lack of information and misinformation throughout the extensive underdeveloped areas of

the world constitute a serious threat to the free institutions of the Western world.

The underdeveloped areas account for about two-thirds of the population of the world. These areas include most of Latin America, Africa, the Near East, Far East, and parts of southern and eastern Europe. The Soviet Union, South Africa, and a number of other countries are in an intermediate position, but much of their territories belongs in the former category.

In the underdeveloped areas agricultural methods are primitive and transportation facilities meager, so that the food supply averages only about 2,000 calories per person per day, an amount inadequate for health. The diet also lacks essential elements, so that malnutrition is general and starvation not infrequent. Life expectancy is low and in 1939 was only about 27 years in India, 30 in Egypt, 37 in Mexico, and 47 in Japan, compared with 62 in the United States for males and 66 for females, and about 66 in the Netherlands and Denmark.

The lack of doctors, nurses, hospitals, and other medical facilities, combined with unsanitary conditions, overcrowding, contagion, and inadequate food means that most of the people are continuously in poor health or sick. It is difficult for them to improve their economy and to produce more so long as they are undernourished, in poor health and illiterate, and so long as they lack modern tools and equipment. The poor conditions also often breed low standards of conduct and lead to inefficient and ineffective government, which add to the difficulty of the problem.

In most of the underdeveloped countries illiteracy ranges from about 70 to over 90 per cent of the total population over ten years of age. The consumption of textiles was, before the war, only about four to ten pounds per person annually in the underdeveloped countries compared with twenty-nine pounds in the United States. The United States had about 250 motor vehicles per 1,000 population, whereas the underdeveloped countries had almost none in some countries, notably China and India (on a per capita basis), and six or eight per 1,000 population in others. The United States had about 148 telephones

per 1,000 population compared with almost nothing up to three or four per 1,000 population in the underdeveloped countries.[2]

Methods of Economic Development.—Most of the underdeveloped areas of the world are not lacking in natural resources or in workers to develop these resources. Much manpower, however, is idle or ineffective. On the basis of productive potentialities a reasonably good standard of living is possible for the peoples of practically all countries. If the world's productive resources were effectively utilized, or even moderately so, the amount of production available to improve consumption would be great. With modern agricultural methods and the land and labor available in underdeveloped areas, the food supply would be ample so that the population of these areas could be adequately fed. Similarly, if resources, manpower, and techniques were properly organized, industrial production could provide for the essential needs of the entire population. In all of the underdeveloped areas the potentialities exist for a greatly improved standard of living (not necessarily, of course, on a self-sufficient basis), and in some cases, particularly in Latin America where the population is not excessive, for a reasonably high standard of living.[3] The problem is how to break out of the vicious circle of illiteracy, poor health, low production, inadequate tools and equipment, and resultant poverty, which in turn leads to illiteracy, poor health, etc.

In countries such as India and China where population is so dense that it presses on subsistence, an improvement in health conditions means a lower death rate and accelerated expansion of population, and consequently less improvement per person.

[2] For further data see "Point Four" published by the Department of State, 1951.

[3] The level to which living conditions may rise in any given country is determined essentially by the amount of resources, including human skills and capital equipment, in relation to the size of the population (see Chapter 10). A country with rich resources, efficient tools, skill to apply them, and a small population has more to consume per person than if resources are poor and population large. None of these factors is fixed and rigid, so the upper limit is flexible.

Much of any improvement in India, China, and other countries in the Far East with a high birth rate and high death rate is absorbed by a growth in population. In such countries education and an improvement in cultural and other intangible conditions will help toward increasing the margin not absorbed by population growth. As countries become more advanced, and as illiteracy declines, the birth rate tends to fall. Marriage tends to be delayed or the size of the family held down in order to maintain desired standards.

In the less densely populated areas, on the other hand, where per capita resources are more abundant improvement can take place more rapidly. The introduction of modern techniques and the provision of education and health facilities can yield prompt results. Improvement gains momentum as it proceeds, since better education leads to better health and larger production, which in turn makes possible further gains in education and health. Economic development can be an accelerating process.

In some of the underdeveloped countries the system of land tenure needs revision. Means must be found whereby large tracts of relatively unused land can be made available for cultivation, and whereby relatively small farmers can have greater opportunities to acquire title to land. Agricultural production is often retarded by the burden of high rents, taxes, and credit terms and by the insecurity of tenure for farm tenants.

Underdeveloped countries often feel that industrialization will contribute to their advancement, and therefore desire to facilitate the establishment of manufacturing and heavy industries. Industrialization, however, with the problems which it brings, may not result in as large a national income and as high a standard of living as expansion of other types of production, such as agriculture, or the development of special natural resources. Certain types of light industries can perhaps advantageously be established, but in the absence of careful studies as to what industries are suited to the country, no generalized conclusion can be reached as to whether extensive industrialization should be sought by a particular country. Diversification of production is usually desirable so as to avoid excessive de-

pendence upon one or two commodities, but this does not necessarily mean industrialization.

Many underdeveloped countries seek to aid industries through tariff protection. A moderate amount of protection may in some cases be helpful to a new and struggling industry, but the danger is that aid will be given to an uneconomic industry not suited to the country, and which will never be able to stand on its own feet. Moreover, a tariff once adopted becomes difficult to remove. This subject has been discussed in Chapters 18 and 19. It is to be noted that in spite of the fact that an industry may be unsuited to a country, and that a tariff may be needed to support it, the country may attach more importance to possession of the industry than to efficiency in production. National objectives cannot always be measured in terms of the principle of comparative advantage.

The underdeveloped countries are suspicious of the industrialized countries and of trade liberalization policies. Some of the underdeveloped countries misinterpret efforts of the United States and other countries to promote general tariff reductions and a freeing of trade from burdensome restrictions, and believe that these efforts represent a desire to prevent industrialization which would offer competition to the industries of the advanced countries, which were themselves, it is charged, built up behind a tariff wall. It is doubtless true that some American businessmen are fearful of industrialization in foreign countries and of possible competition in foreign markets or in the American home market. United States trade liberalization policies, however, are not a reflection of the views of such persons. They are considered to be in the interests of the countries of the world generally.

As a result of the rearmament program and the shortage of certain goods the underdeveloped countries are concerned over difficulties in obtaining equipment necessary for their economic development. In order that economic development programs may not be handicapped but continue at an accelerated pace it is necessary that appropriate priority assistance be extended to exports needed for these programs.

In order to attack the problems of economic development, surveys have been made of countries' economies, of the lines along which development should appropriately proceed, of facilities most urgently needed, of measures which should be taken by the government, and of the kinds of aid, technical, financial, etc., which should be sought abroad. Such a survey, if properly made, is an important first step. Valuable surveys have been made of most of the underdeveloped areas by groups of experts from the United States, the United Nations, the International Bank, etc. The groups are invited by the foreign government and are usually sponsored either by the United States Government or an international agency, although on occasion private groups have been engaged by the foreign government. The surveys are sometimes of a specialized nature and deal with a single subject such as transportation or health, or they may deal with general over-all problems. The quality of surveys has varied, but in most instances they provide a valuable basis or guide to a development program.

One of the difficulties in connection with surveys has been that while there has frequently been no lack of surveys, the report containing the results of the survey, after being received and commended, is too often filed away and forgotten. The problem is often not a lack of knowledge of what should be done so much as the inability or unwillingness of the government to take the actions needed. The government's main interest may have been to serve a political end, to appear interested in reform or development; or more likely the inadequate implementation is due to the slowness and inertia of government processes, plus the unpopularity of certain measures. The foreign government may have insufficient experienced personnel who know how to carry through a program or inadequate funds to carry it out; local interests may interfere with specific measures proposed; or popular understanding of the problems may not provide sufficient support for actions needed to be taken. On the other hand, surveys have frequently led to constructive measures and have facilitated progress under a development program.

A survey report, in order to be most useful, should contain specific recommendations, together with an indication of how these recommendations may be implemented. It should avoid generalities and merely pointing out the obvious. Concrete proposals and suggestions for specific lines of action are more likely to lead to results. A survey mission sometimes needs to be cautious in steering between political issues and in handling sensitive and controversial subjects. It may feel, for example, that an exchange rate adjustment is clearly indicated, but cannot say this publicly without causing financial and perhaps political difficulties for the government. Missions from the International Monetary Fund are in a special position to deal with this particular subject, but they usually find it a delicate matter. A rate adjustment is ordinarily politically unpopular.

A survey is merely a first step. Most underdeveloped countries need technical advisers who remain in the country for an extended period and assist in day-to-day operations. Advisers are usually needed in such fields as taxation, currency, accounting, government administration, health, agriculture, education, social insurance, engineering and a variety of other technical fields. In addition to advisers persons are needed who can participate directly in carrying out projects. Competent advisers and others who with tact and patience can work alongside of local officials, remaining in the background rather than seeking the limelight, and can obtain their good will and confidence, at the same time keeping aloof from political involvement, are not numerous, but can be very useful. As a country's own nationals become trained there is less need for outside advisers and other personnel.

Countries often set goals for the period ahead and announce, for example, a four- or five-year program involving completion of certain specified projects, such as certain highways, hydroelectric plants, new schools, an expansion of particular types of output, etc. Such a procedure has the advantage not only of systematizing the efforts toward development and providing an orderly process, but also of establishing a goal which commands public attention and enlists popular support. Such programs

are seldom fulfilled as contemplated, but they nevertheless serve a purpose.

A development program can be aided and hastened if it arouses the interest, hopes, and allegiance of the public. Cooperation and support from the general public can be especially helpful in such fields as health, sanitation, and education. Some countries have used posters with pictures to advise the public on the importance of cleanliness, sanitation, etc. Posters are also used to give information on free vaccinations and other matters. Public lectures, exhibitions, agricultural and other demonstrations, free literature and radio talks may be enlisted to inform the public and to arouse their interest in progress. The public can be advised of specific measures which they can take to benefit themselves and at the same time further the program.

Financing Economic Development.—While much can be done to improve conditions in underdeveloped countries without large outlays of funds, especially in the fields of education, health, and technology where modest expenditures yield large results, certain types of development require the expenditure of substantial sums of money. Transportation facilities, electric light and power installations, port development, and irrigation projects entail large expenditures. The establishment of industrial enterprises, the importation of farm machinery, construction of housing, or the development of mineral resources similarly require large investments of capital.

Economic development, if it is to proceed far, must thus receive financing in sizable amounts. A conspicuous fact, however, is that in underdeveloped countries productivity is so low that there is little margin left for savings, and therefore little local capital available for financing economic development. Capital formation must compete with urgent consumption requirements and is therefore inadequate to the needs.

While domestic sources of capital are usually relatively small, they can nevertheless be expanded to some extent by appropriate measures. Countries with low incomes and with little margin available for savings frequently have wealthy

individuals who export capital derived from local sources, such as from large agricultural holdings or the exploitation of mineral resources. Wealthy families may live abroad and invest current funds in assets in the United States or in other countries, where the money is considered safe. Relatively poor countries not infrequently export substantial sums of capital. The problem for such a country is not merely that of low savings and insufficient incomes out of which savings can be drawn, but of tapping the existing savings which leave the country, and also the local incomes that can afford to contribute to development.

In most underdeveloped countries the income tax either does not exist or does not yield much revenue. The wealthy class may have prevented its adoption or have succeeded in keeping rates low. The most serious difficulty in the way of increasing the yields from income taxes, however, is that of collection. In foreign countries evasion of taxes, particularly of the income tax, where it exists, is widespread. Governments frequently lack sufficient means of checking up on individuals. In some cases the personnel administering taxes may be inadequate. Failure to report income or to report it accurately is said in some countries to be almost universal. One Minister of Finance commented that there were only a handful of accountants in his country competent to check an income tax return. Reforms in the field of taxation, although difficult in the practical sense, can contribute substantially to a development program.

The governments of underdeveloped countries often rely heavily on customs receipts for revenue, although in many cases this reliance is becoming less. The importance of customs revenues makes difficult the tariff reductions sought by the United States and other countries in the interests of an expansion of world trade and production. Underdeveloped countries, it will be noted, desire tariffs both for reasons of protection and revenue.

Local funds for development can often be increased through measures to encourage savings by those persons able to save, and the investment of such savings at home. In many countries there are almost no facilities available for a small or medium-

sized investor to place funds in profitable use at home. Even large investors may not find it easy to place their funds within the country except in a relatively fixed form such as real estate. Some countries have therefore endeavored to promote a local capital market to mobilize funds. The International Bank recently assisted El Salvador in floating a local bond issue of over $5 million. The issue was fully subscribed within a few days with a broad distribution among financial institutions, business enterprises, and individuals.

A large amount of development has been financed by inflation, in that the government has operated with budgetary deficits which may be attributed to a large extent to development expenditures. Inflation, in fact, is a frequent means of financing economic development. Financing development by inflation, in spite of the consequences of rising prices and balance of payments difficulties, may be undertaken as a deliberate policy with the advantages and disadvantages weighed against each other, but more often inflationary financing is resorted to as the line of least resistance in meeting pressing needs. Economic development is an overriding objective to be attained regardless of inflationary consequences.

Inflation brings results and forces capital formation from the domestic economy, even though rising prices may press on consumption and other difficulties may exist. To the extent that monetary expansion increases economic activity in a sluggish economy and puts unused workers and resources to work it may have its advantages. In most cases, however, the evils of inflation more than offset whatever advantages there may be. While monetary expansion as a method of financing is likely to be abused and cannot be recommended, in certain special cases, such as when development is urgent and other courses are as a practical matter not feasible, or when underactivity is present, it may serve a purpose.

In view of the lack of local capital, economic development, unless it is to be limited and to proceed at a slow pace, needs financial assistance from foreign sources. The amount of the assistance that is required from abroad is of substantial proportions. Foreign funds for economic development may come

from private investment (in the form of loans or direct equity investments in individual enterprises), from other governments (in the form of loans or grants), or from private donations. Foundations, charitable, and religious organizations in the United States have supplied large sums to foreign countries for such purposes as libraries, education, medical and health projects, and to Israel for industrial development, but such funds have been merely a beginning.

Foreign money received as a loan or investment has the disadvantage (sometimes overmagnified), that it may place a burden on foreign exchange resources when earnings or the original principal are to be transferred out of the country. On the other hand foreign investments may greatly increase foreign exchange receipts. From the standpoint of maintaining a particular rate of exchange, additional sums presenting themselves for transfer into a foreign currency (if this should result from a foreign investment) may add to the pressure on the rate, yet if the rate of exchange is to be one which reflects fundamental demand and supply conditions, it should include provision for the transfer of regular earnings and other service on foreign capital.

The funds to be transferred may conceivably require an alteration in the rate of exchange and in the terms of trade, but they are part of the fundamental situation and are to be included as one of the factors which enter into the determination of balance and equilibrium. From the standpoint of maintaining exchange rate stability, however, the existence of sums which regularly require transfer, particularly if in the form of contractual interest, reduces the flexibility in the balance of payments helpful to the monetary authorities in meeting an exchange stringency. Domestic financing is, therefore, preferable to foreign financing, other things being equal, especially for local expenditures.

Development expenditures are ordinarily in large measure for local labor and materials which are already in the country and which must be paid for with local currency. If foreign capital is converted into local currency for local expenditures, and the foreign capital is used merely to add to the country's

foreign exchange reserves, a result of the transaction is probably an expansion of local currency, perhaps with substantial inflationary consequences. (The central bank issues currency in payment for the foreign exchange.) If, however, the foreign exchange is spent for additional imports, such as for goods needed for the project, rather than to buy local currency, no expansion of local currency results directly from the transaction.

The new construction that is undertaken in a development program may increase incomes and thereby lead to a greater demand for imports. In this case foreign capital, if available, would help to meet this additional demand for foreign goods arising indirectly out of the project and would thereby relieve pressure on the exchange rate. The financing of local expenditures with local capital will ordinarily cause less disturbance to the economy and is generally considered preferable to foreign financing of such expenditures, insofar as feasible. Where local financing is not feasible, it may be necessary to call upon foreign capital for local purposes.

The underdeveloped countries are tending to recognize the importance of private investment and are endeavoring to attract private capital from abroad. While they have desired that foreign money come in the form of loans for the financing of government undertakings, they are less confident of government operations as a solution to their difficulties than they were a few years ago, and are looking more toward private enterprise than formerly. Private foreign investment is desired as a supplement to government undertakings, partly because of the difficulty of obtaining sufficient funds for such undertakings, and partly because private capital brings with it the necessary technical, organizational and managerial ability greatly needed in the underdeveloped country.

Private foreign investment has been relatively small (almost negligible on a loan basis) and is not bringing about the economic development of foreign countries to the extent needed. The deterrents to private investment, discussed in Chapter 27, are principally, threats of war, fears of expropriation or competition from government enterprise, burdensome regulations

including interference with control and management, nationalism resulting in actual or threatened discrimination against foreign enterprises, and inability to transfer freely earnings and capital. Furthermore, United States capital does not need to go abroad in order to obtain good profits.

Many governments are endeavoring to remove these deterrents insofar as is within their power. A number are negotiating with the United States treaties of Friendship, Commerce and Navigation designed among other things to assure investors of equitable treatment as discussed in Chapter 31. Public opinion, however, in some cases makes it difficult for the government to encourage private foreign investments, often because of popular fear of domination by large foreign enterprises. In order that the atmosphere for foreign investment may improve, the public must become aware of the benefits from such investment, and that the former type of exploitation by large foreign corporations is largely a thing of the past.

The United States Government has extended a large amount of financial assistance for economic development, principally in the form of loans, and is continuing to provide additional sums. Money for development purposes has been loaned by the Export-Import Bank of the United States Government, and by the International Bank. Most of the funds loaned by the latter bank have also been from capital provided by the United States Government. The loans outstanding of these two banks amounted in the middle of 1951 to about $3½ billion, not all of which, however, were for development purposes.

Several countries have found that the financing of development can be aided by a government development commission which lends money, a "Corporación de Fomento," as that in Chile, a pioneer in this field, is known. These agencies are given governmental funds which they make available to approved undertakings. The establishment of a new business may thus be financed by the development agency. The Export-Import Bank has made large loans to some of these agencies, which then parcel the money out for local projects in accordance with the provisions of the loan, the approval of the Bank being required for each project. These development agencies have,

in general, proved successful, both financially and in promoting development.

Many of the purposes for which funds are needed are of a social, nonrevenue-yielding type, at least in the immediate sense, such as health, education, and highways. Projects in these fields necessarily require public financing, with little or no monetary return, except indirectly and after the lapse of time. Ultimately an elevation of the economy and an expansion of production and incomes will result in greater tax receipts, but these returns may not be available immediately to service a loan. Lending agencies usually shy away from loans for nonrevenue-producing purposes and prefer loans of a self-liquidating type.

The borrowing capacity of an underdeveloped country is ordinarily low, so that the amount of money that can be borrowed, for either revenue-producing or nonrevenue-producing projects, is small in relation to the needs. Borrowing capacity, however, usually increases as the development of the general and social facilities proceeds. This fact is recognized by the International Bank. Its loan to Ethiopia for general public purposes, a departure from its customary procedure, improved the Ethiopian economy, including the ability to service loans.

In view of the lack of borrowing capacity and the dearth of private foreign investment, grants are needed in many cases, especially to help get development under way. Extremely poor countries with meager revenues and little or no borrowing capacity may not be able out of their own resources to make much headway in a development program, particularly in the early stages. Some countries lack the ability or organization to prepare an adequate application for a loan to finance a project. The development of such countries, as well as those farther along, can be expedited by grants. Such borrowing capacity as exists has frequently already been largely utilized and important needs remain unmet.

In view of the need for grants the Economic Cooperation Administration has made large grants for economic development in China, Korea, Southern Europe, Greece, Turkey, South East Asia, and the dependent overseas territories, principally in

Africa, of European countries. The United Kingdom, France, and other countries have provided large grants as well as loans for colonial economic development.

Governmental and intergovernmental loans and grants have played an important role in development, but the amount of such money now available or likely to be available is small in comparison to the large amounts needed. Private investment, both domestic and foreign, is commonly regarded as a potential source for a large amount of the capital needed. The United States, the United Kingdom, and all other advanced countries have been built up with private funds and under the free enterprise system. These have been largely their own domestic funds, although foreign private capital has played an important part in many instances. Economic development must necessarily be the result largely of effective mobilization of local resources.

The problem of the substantially increased amounts of capital which are needed by the underdeveloped countries has not yet been satisfactorily solved. Private capital is not doing the job and may not do the job. Although large sums are being supplied by the United States Government, the International Bank, and private investment, still larger sums are required. Most of the money already provided foreign countries has gone as loans or on an investment basis. Increased grants are needed in the case of many countries which cannot afford to borrow extensively and where a small amount of money properly expended can yield large results. The United States is currently making available increased sums on a grant basis. The grants which the United States made for the reconstruction of Europe increased production there materially and benefited both the donor and recipient. The underdeveloped parts of the world present a different kind of problem, but one which is equally urgent and in the long run of even greater magnitude than that of the reconstruction of war damage.

United States Technical Cooperation Program; "Point Four."—President Truman in his inaugural address in January, 1949, discussed four courses of action which he believed should

be followed by the United States in the field of foreign affairs. The fourth of these points dealt with the making available of technical knowledge to the underdeveloped parts of the world. The program that resulted from these suggestions came to be known as the "Point Four Program."

The purposes and nature of the Point Four Program are best stated in the words of President Truman. He said in his inaugural address:

> . . . Fourth, we must embark on a bold new program for making the benefits of our scientific advances and industrial progress available for the improvement and growth of underdeveloped areas.
>
> More than half the people of the world are living in conditions approaching misery. Their food is inadequate. They are victims of disease. Their economic life is primitive and stagnant. Their poverty is a handicap and a threat both to them and to more prosperous areas.
>
> For the first time in history, humanity possesses the knowledge and the skill to relieve the suffering of these people.
>
> The United States is pre-eminent among nations in the development of industrial and scientific techniques. The material resources which we can afford to use for the assistance of other peoples are limited. But our imponderable resources in technical knowledge are constantly growing and are inexhaustible.
>
> I believe that we should make available to peace-loving peoples the benefits of our store of technical knowledge in order to help them realize their aspirations for a better life. And, in cooperation with other nations, we should foster capital investment in areas needing development.
>
> Our aim should be to help the free peoples of the world, through their own efforts, to produce more food, more clothing, more materials for housing, and more mechanical power to lighten their burdens.
>
> We invite other countries to pool their technological resources in this undertaking. Their contributions will be warmly welcomed. This should be a cooperative enterprise in which all nations work together through the United Nations and its specialized agencies wherever practicable. It must be a world-wide effort for the achievement of peace, plenty, and freedom.
>
> With the cooperation of business, private capital, agriculture, and labor in this country, this program can greatly increase the industrial activity in other nations and can raise substantially their standards of living.

Such new economic developments must be devised and controlled to benefit the peoples of the areas in which they are established. Guarantees to the investor must be balanced by guarantees in the interest of the people whose resources and whose labor go into these developments.

The old imperialism—exploitation for foreign profit—has no place in our plans. What we envisage is a program of development based on the concepts of democratic fair-dealing.

All countries, including our own, will greatly benefit from a constructive program for the better use of the world's human and natural resources. Experience shows that our commerce with other countries expands as they progress industrially and economically.

Greater production is the key to prosperity and peace. And the key to greater production is a wider and more vigorous application of modern scientific and technical knowledge.[4]

The proposal of President Truman attracted widespread interest in the United States and in foreign countries. It met generally with enthusiastic approval. Some foreign countries interpreted the proposal to imply that large-scale financial aid would be forthcoming from the United States Government for development purposes. This interpretation, however, was not that intended by the United States Government. The United States visualized the additional aid that was proposed as being confined principally to technical assistance. The extension of loans and grants by the United States Government is necessarily related to technical assistance, but the announced program looked primarily to the private capital market as a source of needed funds.

Underdeveloped countries are, under the program, expected to help themselves, and in order to obtain funds with which to make the most effective use of the technical aid, are expected to encourage private investment, both domestic and foreign. The adoption of measures to facilitate private investment has not been made a condition to the receipt of technical assistance, but the United States believes that private investment can make a major contribution to economic development, and that as part of a self-help program a country should provide reasonable assurances to investors, with proper safeguards of the public interest. To this end a country should seek to create an at-

[4] *Department of State Bulletin,* Jan. 30, 1949.

mosphere which would facilitate such investment. President Truman, in order to encourage United States foreign investment, recommended to Congress that the Export-Import Bank be authorized to guarantee certain United States new foreign investments against extraordinary risks, particularly inability to transfer funds into dollars, and expropriation without adequate compensation. The 81st Congress, however, did not authorize the proposed investment guarantees.

Congress enacted in June, 1950, the Act for International Development which is the basic legislation for the technical assistance program. The Act contains the following statement of general policy:

> . . . it is declared to be the policy of the United States to aid the efforts of the peoples of economically underdeveloped areas to develop their resources and improve their working and living conditions by encouraging the exchange of technical knowledge and skills and the flow of investment capital to countries which provide conditions under which such technical assistance and capital can effectively and constructively contribute to raising standards of living, creating new sources of wealth, increasing productivity and expanding purchasing power.

The Act authorized the President to extend technical assistance to other countries, such assistance to be either on a bilateral or multilateral basis. Congress appropriated $34.5 million for the program for the first year. The United States allocated $12 million of this money to the United Nations for its technical assistance program, which was expanded as a result of the United States proposal and which is being carried out with the cooperation of the specialized agencies of the United Nations.

Other countries contributed $8 million to the United Nations program which made a total of $20 million for the first year. The Organization of American States also developed its technical assistance program for Latin America, and received financial aid from the United States. Coordination of the various programs is sought through a Technical Assistance Board made up of the heads of various United Nations specialized agencies, and through the Technical Assistance Committee of the Economic and Social Council of the United Nations. The United

States keeps in close touch with these other technical assistance activities.

United States activities in the technical assistance field are carried out both by the Economic Cooperation Administration, ECA, and the Technical Cooperation Administration, TCA (in the Department of State). Through these agencies the United States supplies a requesting foreign government with various types of technical assistance, such as experts from the United States Government or from private sources. The foreign government is expected to pay for a certain portion of the expense, such as the local subsistence of experts. The United States also trains foreign personnel within the foreign country or in the United States. One difficulty in training foreigners in the United States has been that after acquiring training they often desire to remain in the United States where their earnings can be considerably higher than at home. The United States also provides laboratory and other equipment for demonstrations or for pilot projects, and assists in the establishment and maintenance of experimental and agricultural farms, such as that at Turialba, Costa Rica, where trainees come from all parts of Latin America. During the early years of the program emphasis is being given to the fields of agriculture, health, education, transportation, and the development of natural resources. In the middle of 1951 the ECA and TCA together had approximately 500 American technicians in the field in about forty different countries in underdeveloped areas.

The United States has for many years, through both public and private agencies, been rendering assistance and supporting financially various undertakings abroad in the fields of health, education, agriculture, etc. The United States Government has made development loans through the Export-Import Bank and has loaned its experts, usually paying them salaries for extended periods. The program was largely on a bilateral basis and principally in the Western Hemisphere. In the year prior to the Point Four Program the United States spent $7 million in the Western Hemisphere on technical assistance activities.

Most of this aid to Latin-American countries was rendered through the Institute of Inter-American Affairs, discussed in

Chapter 35, a United States Government corporation which has undertaken development activities jointly with other governments. The Institute, working in fourteen countries, has drained swamps and built city water systems and sewage systems. It has organized health clinics and trained nurses and sanitary technicians. It has taught improved agricultural practices, operated grain storage facilities, and organized farm machinery pools. The Institute has also been active in the field of education. In addition, the Department of Agriculture has conducted general agricultural stations in eight Western Hemisphere countries and engaged in research and extension services. Other government agencies such as the Public Roads Administration and the Biological Survey have also rendered assistance to foreign governments. These various activities are now under the Point Four Program.

The program inaugurated by President Truman is thus new principally in its size, scope, centralized status, and method of working to a large extent through the United Nations and the Organization of American States.

The United States, through its technical assistance program, is in the process of providing foreign countries with a type of aid which they urgently need for their economic development. Significant results are already being obtained. In addition to technical assistance, however, larger sums of money are needed than are in sight.

The restless and dissatisfied masses of the underdeveloped areas, about two-thirds of the world's population, frequently intrigued with the Communists' answer to their problem, are demanding that greater and immediate attention be given to their needs. In order to check the Communist menace, especially since the Korean War, larger sums are being provided for economic development. While additional and large-scale outside aid is needed, including that from countries other than the United States, the fact remains that the major part of economic development must necessarily be the result of domestic efforts and organization, and must come from the mobilization of local resources.

Chapter 31

COMMERCIAL TREATIES

History and Nature of Commercial Treaties.—Trade and other economic relations between nations have long been governed to a considerable extent by formal treaties or conventions, as they are sometimes called. The increasing expansion of trade and other business activities across borders raises a number of questions having to do with the rights and privileges of the nationals of the different countries when they are engaged in activities outside their home borders, and the kind of treatment to be accorded to them, their products and properties by other countries. Treaties that deal with such matters are known as commercial treaties.

Such treaties may be of a specialized nature and concerned with a particular subject such as fishing rights, port regulations and fees, smuggling, customs procedures, patents and copyrights, immigration, and taxation, or they may be of a general and comprehensive nature dealing broadly with the rights of nationals of one country to conduct trade with the other, and to establish and carry on business and economic activities generally within the territories of the other country. These general treaties are variously known as treaties of Establishment, of Friendship, Commerce and Navigation, of Amity and Economic Relations, or more recently in the United States as treaties of Friendship, Commerce and Economic Development, the change in title giving emphasis to one of the main purposes of the treaty.

Commercial treaties have a long history. As early as the sixth century before Christ an important commercial treaty was concluded between Rome and Carthage. British commercial treaties date back at least to 1217. Early treaties were

especially concerned not with the rules governing international trade, but with the right to trade at all. The history of practically all countries contains records of various commercial treaties and agreements between the sovereign authorities, usually dealing with matters of trade.

In modern times when legislative bodies exist, a treaty must generally be approved by the legislatures of both countries to become effective. An agreement, on the other hand, which sometimes resembles a treaty, may be made by the Executive, although an agreement may also require legislative approval, in which case it is similar to a treaty.

In the United States a treaty must be approved by a two-thirds vote of the Senate in order to become effective. The Executive, however, may make agreements with foreign governments which may or may not be submitted to Congress, depending upon whether the agreement requires this country to take actions beyond the authority of the Executive. After a treaty has been negotiated and a final draft completed it is signed by high ranking representatives of both countries. It is then submitted to the respective legislatures, the Senate in the case of the United States, and after being ratified by the Executive the ratifications are exchanged and the treaty thereupon enters into force.[1] It usually remains in force indefinitely, although provision is usually made that either party may terminate it after a period such as ten years by giving notice a certain time in advance, perhaps one year. In the United States and other countries, treaty provisions are binding on all governmental subdivisions and override any conflicting federal, state, or municipal laws. A law passed by Congress, however, after a treaty is in force, and intending to modify a treaty provision, will have the effect of preventing the United States from carrying out its treaty obligation.

Treaties may be unilateral, bilateral, or multilateral. In a *unilateral* treaty only one of the contracting parties grants concessions or accepts obligations. Unilateral treaties in the past

[1] Certain procedures, which vary from country to country, are necessary under the constitutional arrangements of the different countries before a treaty becomes effective.

were often forced by stronger nations upon weaker or defeated nations. Unilateral treaties today are rare. The *bilateral* treaty is the most common form and is a treaty between two countries. *Multilateral* treaties are subscribed to by more than two countries. Such treaties are constantly increasing in number and importance. Multilateral treaties have dealt mainly with cable and radio matters, international postal charges and other postal matters, patents and copyrights, and weights and measures. Multilateral agreements have been more common than multilateral treaties.

An important provision in almost all commercial treaties is the most-favored-nation clause, referred to briefly as mfn. Such a provision means that the treatment accorded to the nationals, products, vessels, etc., of the other party to the treaty shall be no less favorable than the treatment accorded to the nationals, etc., of any third country in like situations. This provision thus guarantees that all concessions granted by either party to a third nation shall be immediately extended to the other party to the treaty. Its origin dates back to the Middle Ages when in the developing trade between Europe and the Middle East the Western cities and states sought commitments that they would receive as favorable treatment from the Middle East countries as that given to other Western cities and states by such Middle East countries.

As noted in Chapter 17, most-favored-nation clauses are of two types, unconditional and conditional. The unconditional type requires that each country extend to the other all concessions or favorable treatment accorded by it to a third country, regardless of any concessions or favorable treatment that may have been accorded in return by such third country. The conditional type, on the other hand, assures most-favored-nation treatment by one party to the other, provided such other party accords favors equivalent to those granted by the third country. The unconditional form, which is the one now almost universally utilized, promotes equality of treatment among all countries having such an mfn treaty provision. It provides that no one nation shall be favored more than the others, and that if any favor is granted to one country it is automatically extended

to all the other countries. The conditional form on the other hand, in addition to not promoting equality of treatment, has the drawback that determination of just what is an equivalent concession is usually difficult and the source of disagreement. In spite of its disadvantages the United States adhered to the conditional mfn principle during most of this country's history until after the first World War.

The term *national treatment* is used frequently in commercial treaties and means that the nationals of one party to the treaty shall be accorded treatment by the other party no less favorable than such other party accords to its own nationals in like situations. It means that the nationals of each of the treaty countries shall not be discriminated against within the other country but shall enjoy all the lawful rights and privileges of the nationals of such other country. Certain exceptions, of course, may be written into the treaty for security or other reasons.

The lack of a treaty between two countries does not, of course, mean that the nationals of these countries have no rights or privileges within each other's borders. International law and custom provide certain rights and privileges for aliens regarding such things as the administration of justice and the treatment of them and their property. Furthermore, in all countries domestic laws apply in most cases to nationals and aliens alike. Ordinarily aliens receive treatment similar to that of nationals. Important exceptions, however, exist so that treaties fill an important need.

United States Treaty Program.—The commercial treaty program of the United States dates back to 1776 when the Continental Congress made plans for such treaties which it hoped to negotiate with a number of foreign countries. It was believed that such treaties would strengthen this country's independence economically and politically. Benjamin Franklin and John Adams served on a committee which drew up an outline of what was considered a model treaty for this country at that time.

The first treaty to be negotiated by the United States was with France which went into effect in 1778. It was called a

Treaty of Amity and Commerce. Since then over 100 commercial treaties of a general nature have been negotiated and put into effect by the United States. These treaties are not all in effect today although a number are in effect that date back many years. The oldest commercial treaty of this country still in force is that with Great Britain concluded in 1815. Some other early treaties are those with Denmark (1826), Morocco (1836), Colombia (1846), Costa Rica (1851), Netherlands (1852), Argentina (1853), and Bolivia (1858).

The primary objectives sought by the United States in its various treaties have changed with the times and reflect conditions prevailing at the different periods in the country's history. The earliest objective, as noted above, was to strengthen the economic and political bases of the young republic, which had just declared its independence. Commercial treaties with foreign governments, it was thought, would bring prestige as well as certain specific advantages.

During the period from the Napoleonic Wars until the Civil War in the United States, this country had a large and prosperous merchant marine. The country was well suited, with its abundant forests and forest products close to the sea, to the building of ships. It also had the skill to man the ships, then sailing vessels, since this country, developing along the sea coast, was largely dependent upon water transportation and overseas sources for many products. Ships and their operation were familiar to Americans. Until iron and steel steamships replaced wooden sailing vessels after the Civil War this country was a leading maritime nation, and was especially concerned with navigation matters and the treatment accorded its ships and sailors by other countries. It is logical therefore to find that commercial treaties during this period gave primary emphasis to shipping matters, particularly to the prevention of discriminatory dues and regulations when the ships were in foreign ports.

As this country's manufacturing industries developed extensively, beginning in the latter part of the last century, and its exports of manufactured products, accordingly, increased, the

country became interested in the treatment accorded its goods by other countries, particularly tariff treatment. Tariffs have ordinarily applied more to manufactured goods than to agricultural products and raw materials, which latter commodities had previously been this country's principal exports. During the period from the end of the Civil War until after the first World War the United States negotiated only a few general commercial treaties, although it concluded a substantial number of executive agreements. The treaties and agreements of this period gave special attention to trade problems, to tariffs, preferences, and other commercial policies affecting commodity trade.

After about 1900 the United States began to invest substantial sums abroad and to establish enterprises in foreign countries. During the 1920's the outflow of capital was especially large and American-owned enterprises sprang up in various parts of the world. United States citizens became more interested in their rights in foreign countries and in the kind of treatment they and their property were entitled to receive. Treaties negotiated during the 1920's and 1930's, therefore, gave considerable attention to the rights and privileges of United States nationals and companies carrying on activities within a foreign country.

Since the end of the second World War the United States has pursued a program of negotiating new and revised treaties of Friendship, Commerce and Navigation, or Friendship, Commerce and Economic Development as the more recent ones are sometimes called. These negotiations are with countries with which the United States did not previously have treaties, or are in substitution of existing but antiquated treaties. In the postwar period the United States has been endeavoring to facilitate the economic development of underdeveloped countries, and to this end has sought to encourage the flow of private investment capital into such countries. It has also desired to revive the flow of private investment in order to increase the supply of dollars in foreign lands and to help finance United States exports thereby reducing the surplus in this country's international ac-

counts. The revised treaties therefore contain new provisions regarding assurances to investors, reflecting the current needs of the United States and other countries.

In recent years all governments have expanded greatly their economic functions and their regulations over private business. In this process abuses have existed and there have been cases where the rights of investors have received inadequate attention, or have even been ignored entirely, such as when properties have been nationalized and the owners given little or no compensation, or when foreign companies have been discriminated against in the application of regulations. Treaties currently being negotiated therefore give special attention to assurances to investors of capital, aiming to protect investors against discriminatory or unreasonable actions on the part of the foreign government. Earlier treaty provisions in this field have been expanded and improved.

Treaty assurances to investors cannot, of course, by themselves bring about any large flow of new foreign investment in the face of the deterrents discussed in Chapter 27. Such assurances can, however, improve the atmosphere for investment and thereby contribute to the establishment of conditions favorable to investment.

Since the end of the second World War treaties in the revised form have been negotiated and have gone into effect between the United States and a number of countries, namely, with China, Italy and Ireland. Treaties have been signed with Uruguay and Colombia. Negotiations with other countries are under way. While the United States desires to have treaties with as many countries as possible, the United States does not seek treaties with countries which do not recognize the mutual benefits and wish to have such a treaty with the United States. The value of a treaty is weakened unless the foreign country enters into the negotiations wholeheartedly and without pressure. The treaties involve fundamental principles of the kind which the United States believes should be accepted by countries because the principles are recognized as just and proper. The principles are of a type which are generally observed in any event by most countries.

Provisions of United States Treaties of Friendship, Commerce, and Economic Development.—The treaties which the United States is now negotiating with a number of countries, and which have already been put into effect with certain countries, have been revised and improved with particular attention to assurances to investors. The changes are in large part designed to provide security and equitable treatment for United States private enterprises in foreign countries. An objective is to facilitate economic development through creation of conditions which will contribute to the flow of private foreign investment. The phrase "Economic Development" thus appears in the title of some of the newer treaties. The treaties are also sometimes referred to as "Investment Treaties." While new material has been added, the length of the treaties has been substantially reduced due to simplification and the elimination of cumbersome phraseology.

The United States in its treaty negotiations does not ask for special favors, nor for treatment for its nationals by the other country better than the United States itself accords to foreigners within the United States. The provisions of the treaties are thus reciprocal, applying to both countries equally, with a few minor exceptions due to legal difficulties. The various treaties are not identical because of the special needs of the different countries, but their main provisions are essentially alike.

In addition to provisions dealing with elementary matters such as the right to enter a country, to reside and travel within its borders, and to receive reasonable protection, the treaties provide that nationals may carry on certain types of economic activities within each other's territories. Those fields such as manufacturing, distributing, etc., which are to remain open freely to foreigners are specified in the treaties. Most countries reserve certain fields such as public utilities, radio broadcasting, communications, etc., to their own nationals for security or other reasons. These reasons, in the United States and elsewhere, are often largely a desire to favor one's own nationals, rather than to meet a security or other important need. The United States restricts the participation of foreigners in such fields as shipping, banking that involves the receipt of deposits

or fiduciary functions, and certain mineral and agricultural activities. The United States restrictions of this type on aliens are in reality minor, and in practically all cases aliens in the United States enjoy the same rights to engage in business as do United States citizens. Foreign countries are in most cases inclined to limit the economic activities of aliens more than does the United States. This country is so large that alien businesses are not likely to control or become a major factor in the country's economic life.

A number of foreign countries admit foreign enterprises only after specific government approval, and therefore in their treaties desire to retain the right to screen new foreign undertakings prepared to enter the country. The reasons for selective admission are generally to see that the new enterprise is consistent with the country's general economic plans and interests, that it will not unduly burden foreign exchange reserves especially when profits are to be transferred, and also, although not always admitted officially, that it will not compete with existing domestic industries.

The admission of new enterprises on a selective basis can be a departure from the historic open-door policy, namely, equal opportunity for the investors of all nations, depending upon the nature of the screening administration. This subject is discussed in Chapter 28, United States Foreign Investment Policy. The administrators of screening machinery may attempt to treat nationals of all foreign countries equally, but the admission of an enterprise and the denial of another almost inevitably involves a certain amount of discrimination. A guarantee of most-favored-nation treatment with respect to entry is therefore of doubtful value when accompanied by the screening of new enterprises. More important than free entry, however, is an assurance of national or nondiscriminatory treatment of enterprises that are admitted.

A fundamental principle embodied in this country's treaties is that of national treatment, mentioned above. The United States seeks to have its citizens and their enterprises in foreign countries accorded, with a few exceptions, treatment as favorable as that which a country accords to its own nationals in like situa-

tions. This is the important principle of nondiscrimination. If a foreign government fails to accord to its own nationals treatment that conforms to generally accepted standards of justice and reasonableness, the United States is, nevertheless, not bound to accept such unjust national treatment for United States citizens. The treaties thus provide for certain minimum or absolute standards of treatment in addition to national treatment.

In fields where assurances of national treatment cannot be provided in the treaty, because, for example, of certain sensitive industries reserved to a country's own nationals, provision is made for unconditional most-favored-nation treatment. This provision assures United States citizens that in those special and defined cases where national treatment is not obtainable, they will be accorded treatment at least as favorable as that accorded to nationals of any other country.

An important provision in the treaties deals with the subject of expropriation. A government, of course, has the right to nationalize an enterprise if it so wishes, but the treaties provide that in such an event the owners shall receive adequate and prompt compensation. If the compensation is paid in local currency, the recipient has the right to transfer the money into dollars on a basis that is defined in the treaty. Such compensation is freely transferable unless the country has a foreign exchange stringency, in which case exchange priorities may be given, but only for payments for imports essential to the health and welfare of its people. Withdrawal of the compensation is to rank high in the schedule of exchange allocations.

Some countries have laws requiring the employment of local workers in certain percentages of total employees, or that local capital and management participate in the enterprise. For example, it may be required that at least eighty per cent of all employees be nationals, or that at least fifty-one per cent of the stock of certain enterprises be owned by nationals. In order that such laws, present or future, may not take control away from a foreign enterprise that has been lawfully established, or otherwise unreasonably interfere with its operations, the treaties provide that nationals of the other country shall have the right of effective control and management of enterprises that they

have been allowed to establish. A government may take over an enterprise, paying just compensation, but it cannot merely take control away from the owner, or require that he employ local personnel to the point where it interferes with his effective management of the enterprise.

The treaties also provide that with respect to technical experts an owner may employ such experts as he desires within the country regardless of their nationality. He thus cannot be required to employ only local technical experts.

As a result of the prevalence of exchange restrictions investors have in many cases not been able to withdraw freely their earnings or to return their principal in whole or in part. The new treaties deal with this problem in detail. They provide for freedom to transfer profits and earnings of all kinds, and to return principal, subject, however, to the condition that in periods of exchange stringency a country may impose exchange restrictions to the extent necessary to provide for imports of goods and services essential to the health and welfare of the people. Furthermore, if such restrictions are imposed the country must make reasonable provision for the transfers mentioned, and must provide opportunity for consultation on problems which may arise. Variations in the wording occur but the principle is essentially the same.

The treaties also provide that taxes shall conform to the principle of national treatment, that foreigners be taxed on the same basis as nationals, or in special cases where national treatment is not feasible, that the principle be that of the most favored nation. The United States also negotiates what are known as double taxation treaties which deal with federal income and inheritance taxes and seek to avoid an overlapping of taxes imposed by different governmental jurisdictions. Double taxation treaties do not deal with state and municipal taxes. The treaties of Friendship, Commerce and Economic Development (or Navigation) seek to establish general principles applicable to all forms of taxation. These principles are those of nondiscriminatory tax treatment of aliens, e.g., national or most-favored-nation treatment with respect to all taxes.

Double taxation treaties are in force between the United

States and Canada, Denmark, France, the Netherlands, Sweden and the United Kingdom. Such treaties have been signed, and are pending before the Senate, with Belgium, Greece, Ireland, New Zealand, Norway and the Union of South Africa. Technical discussions are underway with other countries. It is to be noted that American companies operating in foreign countries are entitled to deduct from income taxes payable to the United States Government income and profits taxes paid to foreign governments on income derived from sources outside the United States, subject to certain technical requirements. In view of this tax credit there is relatively little double taxation of American companies operating abroad.

Other subjects dealt with in treaties of Friendship, Commerce and Navigation include duties and other charges on commodities, competition of state controlled enterprises (the treaties endeavor to make available to foreign enterprises any favors conferred on state-controlled enterprises in competition with them), and in some cases navigation matters.

One of the fundamental aims of the treaties is to provide bases for the diplomatic and juridical protection of United States economic interests abroad. The treaties provide that any dispute regarding any provision of the treaty not settled satisfactorily by diplomacy, or other peaceful means, may be submitted to the International Court of Justice, located at the Hague. The treaties are in force for at least ten years, and thereafter may be terminated by either country upon one year's notice to the other.

Chapter 32

COMMODITY PROBLEMS AND AGREEMENTS

Nature of Commodity Problems.—Commodities, whether raw materials, manufactured articles, minerals, or agricultural products, have long been the source of international economic and political problems. Governments have contested and even resorted to war for possession of raw-material areas, and also for markets in which to sell their products. Governments have often been keenly interested in assuring the availability to their country of certain commodities. They have also sought to protect or advance the interests of their producers of particular commodities. Such producers have themselves not infrequently made agreements or arrangements with producers in other countries designed for their mutual advantage, but not necessarily for the advantage of consumers of the products. Governments have at times participated in these agreements or arrangements.

Fluctuations in the production or consumption of commodities take place constantly and are frequently the source of difficulty to producers and others. A series of bumper crops or a shrinkage in consumption, perhaps because of depression, may lead to price declines and to losses to producers. The losses may also affect workers and their families dependent directly or indirectly upon the production of the article. In the case of some countries which concentrate on the production of certain commodities these people affected may represent a substantial part of the population. Commodities may also experience a sharp rise in price as was the case with respect to raw materials accompanying the rearmament program. Consumers are harmed by these rises in prices.

The fact that the national income of a country is in some cases closely linked with the fortunes of a few commodities, and that the welfare of a large mass of people rises or falls with the prices of such commodities, has led governments, especially in recent years, to take specific actions in behalf of these commodities. These actions have been almost entirely in the interest of producers. The interests of consumers have been commonly ignored. Such actions have been both in the domestic and in the international field, and ordinarily, have had as their aim a higher price of the commodity and also a more stable price. Domestic measures to raise the price of a commodity, or otherwise to aid its producers, usually have significant international repercussions, such as loss or reduction of export markets through increased production of the commodity abroad, or various retaliatory actions on the part of foreign countries. Inasmuch as international trade is to a large extent trade of commodities, the commodity problem is a broad one. The present chapter is concerned with certain international aspects of the production, marketing, and prices of commodities.

Rivalry for Raw Materials.—Modern industry requires a great variety of materials which are scattered unevenly throughout the world. Some countries have generous supplies of minerals essential to industry while others have none. Rich agricultural lands abound in certain areas whereas in others the land is largely barren. The uneven distribution of resources makes nations to a greater or less extent dependent on one another, and is a basic reason for trade. The United States surpasses most other countries with respect to the diversified nature of its resources, but the United States lacks completely or almost completely such articles as natural rubber, manganese, nickel, chromite, tungsten, antimony, tin, and various tropical products. Small countries lack a great many important resources, and are especially dependent upon other countries in their economic life. The development of synthetic materials to fill the gap may be possible but not economically feasible except in cases of emergency, since synthetic products are usually more expensive or

less desirable than the natural products. The leading producers of the principal raw materials are shown in Table 11.

Countries are not only interdependent in securing essential materials, but are also interdependent in selling materials which they possess. Only as a nation can sell to other nations its raw materials, manufactures, or services can it obtain from abroad those articles and services which it requires. During the early stages of industrial development countries depend largely upon the export of raw materials and primary products in order to acquire articles needed from abroad. This was the experience of the United States during the nineteenth century. As they advance, their production usually becomes more diversified, although they may continue to specialize in the production of certain products.

The penetration by advanced nations of underdeveloped areas, a process which has been under way for centuries whether peacefully or by means of force, has represented in large part the quest of raw materials and markets, and for the power which their possession was believed to bring. Capital and traders entered underdeveloped areas seeking opportunities for profits, and in some instances were given military and financial assistance by their home governments. The historic abuse and exploitation of backward peoples, however, is now largely a thing of the past as far as the Western world is concerned. The spreading of the technical knowledge and capital of the advanced countries into the underdeveloped areas is taking place on a basis of mutual respect and advantage. The investment of capital and skill internationally facilitates economic development and in most instances is now undertaken with regard to the interests of the recipient area as well as of the investor.

The rapid industrial development of certain nations and the slow development of others have been due in part to the existence or lack of certain resources. The early start which England obtained in industry was in no small measure due to excellent British coal and iron deposits. Lack of coal and iron has been a handicap to the industrial advancement of certain countries.

From the economic standpoint the mere physical existence of a certain raw material is not necessarily of much significance.

TABLE 11

LEADING PRODUCERS OF RAW MATERIALS, 1947

Raw Materials	Leading Producers					
	1		2		3	
METALS		%		%		%
Iron ore 1946	U. S.	47	Russia	14	France	11
Copper 1945	U. S.	32	Chile	21	Canada	10
Lead	U. S.	31	Mexico	17	Australia	13
Zinc	U. S.	48	Canada	11	Belgium	9
Tin 1948	Malaya	29	Bolivia	25	Neth. E. Ind.	20
Aluminum	U. S.	48	Canada	25	Russia	11
Manganese ore	Russia	49	Gold Coast	16	India *	9
Nickel	Canada	77	Russia	18	N. Caledonia	2
Chromite 1942	Russia	20	So. Rhod.	17	U. So. Afr.	17
Tungsten ore	China	27	U. S.	11	Bolivia	10
Molybdenum	U. S.	88	Chile	3	Canada	1
Vanadium	U. S.	56	Peru	25	S. W. Africa	16
Antimony	Bolivia	29	Mexico	18	U. S.	13
Mercury	Italy	37	Spain	25	U. S.	16
Gold	U. So. Afr.	41	Russia	22	Canada	11
Silver	Mexico	40	U. S.	28	Canada	11
OTHER MINERALS						
Coal	U. S.	38	Germany	15	U. Kingdom	12
Petroleum	U. S.	61	Venezuela	14	Russia	6
FOODSTUFFS						
Wheat 1947-48	U. S.	24	China	16	Russia	15
Rice .... "	China	32	India *	28	Japan	8
Sugar .... "	India *	20	Cuba	19	U. S.	6
Coffee .... "	Brazil	54	Colombia	21	El Salvador	5
TEXTILE FIBERS						
Cotton 1947-48	U. S.	51	India	12	Russia	11
Flax 1946	Russia	51	Belgium	8	France	7
Wool	Australia	27	Argentina	13	New Zealand	9
OTHER PRODUCTS						
Tobacco	U. S.	29	China	20	Brazil	3
Hemp (soft) 1946	Italy	22	Russia	19	Turkey	5
Hemp (hard) .... "	Tanganyika	32	Mexico	29	Philippines	9
Jute	India *	97				
Rubber	Malaya	51	Neth. E. Ind.	23	Ceylon	7

* Including Pakistan.

(Source: *Commodity Yearbook, 1949,* compiled mainly from reports of United States Bureau of Mines and United States Department of Agriculture; and *Industrial Fibres* Report of Commonwealth Economic Committee issued in London in 1948.)

Only as the material is exploitable and accessible to markets does it enter the international economic sphere. Raw materials in remote and inaccessible parts of the world, or where political conditions make them unavailable, or where the demand for various reasons does not call them into use, are not part of the

immediate economic picture. Improved technology, transportation, or changes in demand may, however, alter the situation at any time.

The uneven distribution of resources has been a prominent factor in determining the industrial development of nations, and also the direction of world politics and history. Nations have continually struggled with one another for possession of resources deemed essential to national existence or which it was thought would add to the nation's power. It is easy to overemphasize raw materials as a cause or contributing cause of war, yet insofar as nations have desired to exercise political control over areas containing important resources, conflicts of interest have at times developed. Although raw materials have usually been readily available in the world's markets to any purchaser, nations have nevertheless desired political control over areas producing such materials. In the desire to build empires, nations have found the possession of raw materials a seemingly plausible objective to hold before the public.

During the period preceding the outbreak of war in 1939, much was said concerning rivalry over raw materials, and their relation to war and peace. It was sometimes argued that the main cause of war lay in the uneven distribution of the important industrial raw materials. It was held that nations which possessed a wide variety of essential raw materials—the so-called "haves"—tended to be peace-loving, while those countries which were lacking in such materials—the "have-nots"—tended to be war-minded. War was condoned in some quarters on the grounds that the "haves" were not willing to hand over rich territory to the "have-nots." History was said to be largely a record of contest for necessary resources and markets. The prestige of this theory was enhanced by dictators who declared that the unequal distribution of resources was the cause of the world crisis. They informed the world that their countries must have more territory and colonies as a source of vital raw materials, and as an outlet for an excessive number of people and products. They attempted to justify aggression on economic grounds. Hitler thus demanded *Lebensraum* for Germany.

Regardless of the fallacies in these contentions, there has been keen rivalry for control over raw materials.

The above line of reasoning, which has had many adherents, raises several important questions. What hindrances have there been, if any, to the securing of necessary raw materials? In what ways, if any, does political control over a territory aid in obtaining raw materials? What was the real basis for the extensive rivalry for resources and the efforts toward national self-sufficiency which took place during the 1930's? Was it because nations were unable to secure on reasonable terms raw materials from regions which they did not politically control? Would a redistribution of territory among the leading nations with the aim of securing, as far as possible, national self-sufficiency have reduced friction and promoted peace, economic well-being, and a fuller use of resources?

A little scrutiny reveals that during the period of greatest rivalry, raw materials were in general available to all comers on approximately equal terms. During the 1930's raw materials were freely available at prices, with a few exceptions, that were the same for nations of the country which possessed the territory as for nations of other countries. Raw material producers were confronted with depressed markets and low prices and were only too willing to sell to whoever had money to buy. While raw materials were readily available without substantial discrimination, several important raw materials were subject to control arrangements designed to benefit producers. Such commodities included rubber, tin, sulphur, coffee, nitrates, aluminum, copper, sugar, etc. The effect of the controls was in most cases a slightly higher selling price. The controls, however, did not interfere to any great extent with the availability of the commodities.

The impression has been common that colonies and dependent territories are a special aid in the obtaining of raw materials, an impression which is largely, but not entirely, incorrect during recent generations. Having a nation's flag flying over a colony has been of some but not great importance in the matter of obtaining raw materials, particularly since colonies need the world market as an outlet for their production. According to the

League of Nations Committee on Raw Materials, colonial production of commercially important raw materials accounted before the war for only 3 per cent of total world production of these products.[1] Among the important products which came largely from colonies and which were sold all over the world were rubber and tin, 91 per cent of the former and 58 per cent of the latter coming from colonial sources in the years immediately preceding the second World War. While most countries with colonies did not reserve special privileges for their own nationals in the purchase of raw materials, the League of Nations Committee on Raw Materials pointed out that, nevertheless, such nationals did enjoy to some extent a favored position. In general, however, raw materials were freely accessible to all on relatively equal terms. A shortage of foreign exchange resources was not an uncommon barrier to the purchase of desired materials, but this was an economic rather than a political barrier.

Some of the most prosperous nations have been those without colonies and with only a few resources, and therefore extremely dependent upon foreign nations. These have included such countries as Switzerland, Sweden, Czechoslovakia before the war, and certain Latin-American countries. Political control over a territory in the prewar period of contest for raw material areas appears to have yielded little net economic advantage.

The situation since the war is different in view of the general extension of governmental regulatory activities. The regulation of the economic life of a territory provides an opportunity for influencing its production and foreign trade in a manner favorable to the controlling country. Exchange regulations, import and export quotas, and other control devices permit discrimination in favor of the parent country. Such devices tend to increase the flow of trade between the two areas. While the eastern European countries are not colonies of the Soviet Union in the customary sense, their trade has been regulated extensively in the interests of the Soviet Union. Countries that still possess dependent territories are generally inclined to recognize the

[1] League of Nations, *Report of the Committee for the Study of the Problem of Raw Materials* (Geneva, Switzerland, 1937).

rights and aspirations of the local population, and that the economic affairs of the area should be directed in the interests of such population. Nevertheless, in most cases, controlling countries do seek, and to a certain extent obtain, trade advantages in their dependent territories.

The prewar rivalry for raw materials and efforts toward self-sufficiency were stimulated by the threatening political situation. Nations which planned aggression, as well as nations which sought to protect themselves against aggression, endeavored to obtain control over essential sources of supply, to develop substitute materials, and in general to be as independent as possible from outside sources. Nations felt themselves forced by the threatening international situation, as well as by the restrictive policies of others, into efforts to corral resources and to pursue nationalistic and uneconomic policies. The trend toward self-sufficiency, not only in raw materials, but in other fields, was also a result of the widespread trade and exchange difficulties accompanying the depression, and the resulting restrictive policies as discussed in other chapters.

A close connection existed between raw materials and war, but instead of the unavailability of raw materials for peacetime uses being a cause of war, it was rather preparations for war and the fear of war that caused nations to contest for resources. Moreover, during a war certain raw materials are especially necessary. This fact was another reason for the desire for political control on the assumption that political control over raw materials would assure their availability in wartime. The accessibility of raw materials in wartime is, however, largely a military rather than a political matter. Political control over strategic materials does not necessarily assure their availability in wartime. Stock-piling is a partial answer but is difficult and expensive, especially in view of the great amount and variety of materials needed for modern warfare.

With the uneven distribution of raw materials, it would obviously be impossible to divide the earth's territory so that each nation could be even approximately self-sufficient, except perhaps on a primitive agricultural basis. To adjust boundaries in such a way that the approximately seventy independent sovereign

nations could be self-contained, each having within its borders the essential raw materials, is clearly out of the question. Even if this aim of self-sufficiency could somehow be achieved, each nation would be poorer than under a regime of international specialization and trade. To secure a maximum amount of goods and services for the peoples of the world it is necessary that there be a maximum rather than a minimum of international specialization and division of labor, a maximum rather than a minimum of trade and interdependence. A solution to the problem of availability of raw materials is not to be sought in the direction of self-sufficiency or political control over areas, but rather in the direction of international cooperation, removal of trade barriers and measures to promote currency convertibility.

Commodity Surpluses.—Certain types of commodities, especially agricultural and other primary products, are subject to rather wide fluctuations in price and to conditions which at times bring distress to producers. The production of agricultural and certain other commodities does not adjust readily to changes in demand and in other conditions affecting production, prices, and sales. Producers are slow to move out of agriculture into other lines of activity so that most agricultural production does not respond promptly or adequately to lower prices. Surpluses persist year after year, except during war emergencies, and have tended to become chronic. Prior to the rearmament program surpluses were beginning to reappear.

The word "surplus" is somewhat ambiguous. In one sense (i.e., in a free market economy) there can never be a real surplus since the market can always be cleared at some price. If this equilibrium price is lower than is considered desirable, support measures to maintain the price above this level will result in stocks which are not consumed. A more useful concept of the word, conforming to common usage, refers to the utilization of more resources in producing the total supply of a commodity than can, when utilized efficiently, earn what may be considered a "normal" or "fair" rate of return. The allocation of resources to the production of the different kinds of commodities is con-

stantly shifting and frequently becomes out of adjustment with the demand for an article. When more of a commodity is produced year after year than can be sold at a price to yield a reasonable rate of return to the labor and capital employed in its production the commodity may be said to be produced in surplus.

Significant technological improvements have taken place in agricultural methods which have increased output materially. These improved methods have been a major factor in the continued surpluses. The increase in market demand for agricultural products has not in recent decades kept pace with the expansion in output, although this condition was temporarily relieved during and after the war by wartime and rearmament shortages. During the past three decades the terms of trade, reflecting the surpluses, have tended to move against agricultural and other raw material areas and in favor of industrial areas. The shift of resources excessive to agriculture and other primary products into other types of production, however, has been sluggish. When shortages exist as during emergencies, the pressure is, of course, in the other direction.

Improved living standards and a high level of employment have increased consumption and assisted in the absorption of excess production, but these factors have not resulted in a sufficient increase in consumption to absorb all the surplus. In economic terminology, the income elasticity of demand for basic foodstuffs and other primary products is low, larger incomes not being accompanied by a very great increase in demand, which fact contributes to the long-range difficulties (temporarily in abeyance) which appear to be facing these commodities.

The large number of people employed in the production of an agricultural commodity and the dependence of their incomes upon its price create a special problem. When a country leans heavily upon the production of one or two commodities, the market demand and prices of those commodities become particularly important to that country and to the incomes and welfare of its people. Moreover, if the commodity is a principal export, the country's foreign exchange position may be adversely affected by a decline in price or in the volume of exports. In periods of surplus production and depressed prices governments

are under strong pressure to undertake measures on behalf of commodities important in the country's production.

Resulting unilateral actions by governments may take the form of subsidies to producers, either domestic or export subsidies, price support or valorization arrangements, import quotas or various other measures. Actions of this kind, although they may provide temporary relief to producers, usually have contributed little or nothing to a fundamental solution of the problem since they seldom have been accompanied by effective measures to reallocate resources. On the contrary, by supporting prices at too high levels they have tended to encourage a continuance of surplus production. They may also be damaging to other exporting countries, especially if they involve export subsidies, and lead to retaliatory measures. Whether domestic production is curtailed in conjunction with price support measures or whether production is left to its own devices, the measures may stimulate production abroad and thereby aggravate the problem. Under a support program surpluses pile up rapidly and the program becomes increasingly expensive to the government, as United States experience has shown, although special and unanticipated emergencies have relieved United States surpluses. Most countries cannot afford to pursue such policies except for short periods of time.

Commodity Agreements.—In an effort to deal with commodity surpluses, producers in different countries have frequently entered into agreements designed to restrict production or marketing of the commodity in question, and thereby to raise its price. Governments have often participated in these agreements.

Commodity agreements were developed especially during the 1920's and 1930's. The agreements originally were usually between private producers and constituted in effect a cartel, as discussed in the next chapter. The participation of governments in the agreement usually came at the solicitation of producers, since there was a tendency for the private agreements to break down, or since government authority was needed to bring into the agreement recalcitrant producers. Commodity agreements

also grew out of governmental measures to support prices, valorization plans as they were sometimes known. Commodity agreements covering tin, rubber, tea, etc., had their origins in private cartels, whereas agreements covering coffee, sugar, etc., had their origins in national efforts to deal with surplus production of these commodities.[2]

Commodity agreements take a variety of forms and may be directed toward different objectives although the principal objective is a high and relatively stable price. The commonest type of commodity agreement is one between the governments of the principal exporting countries of a certain commodity (the aim being to include all such countries), and perhaps the importing countries also. The agreement is designed to regulate the world distribution and price of the commodity in question. Such an agreement is known as a multilateral commodity control agreement and is illustrated by the International Wheat Agreement described below. Consumer interests may or may not be represented in these agreements.

The Wheat Agreement, which went into effect July 1, 1949, for a four-year period, was signed by forty-one nations, including consuming countries, but not ratified by all of the signers. According to the agreement the participating importing countries guarantee to purchase from the participating exporting countries designated quantities of wheat at the minimum or floor prices established in the agreement, when so requested by the exporting countries. This arrangement provides an assured market and minimum price for the wheat producers. On the other hand, the exporting countries guarantee to sell to the importing countries, when requested by the latter, designated quantities of wheat at the maximum or ceiling prices established in the agreement. Importers are thus assured supplies of wheat and the maximum price they must pay. The guaranteed quantities may be adjusted under certain

[2] The Brazilian government according to its valorization scheme begun during the 1920's undertook to deal with its surplus coffee by withholding it from the market. Stocks became unwieldy and in an effort to keep stocks and consumption in balance the government during the 1930's destroyed coffee equivalent to about three years of total world consumption. Cuba similarly endeavored by its own efforts to deal with a chronic surplus of sugar.

conditions. For the first year the maximum price was $1.80 per bushel and the minimum price $1.50 per bushel, the amount going down by ten-cent intervals to a $1.20 minimum the fourth year. The participating exporting countries are the United States, Canada, Australia, France, and Uruguay which together guarantee to supply approximately 456,000,000 bushels each crop year, the amount for each country being fixed. The participating importing countries include a long list of countries, each with a specified quota.

The agreement establishes the International Wheat Council, with headquarters in London, on which each country is a voting member with votes based on the size of each country's guaranteed purchase or sale during each of the four crop years. The total votes of the importing countries are equal to the total votes of the exporting countries. Each country may fulfill its guaranteed quantity through private trade channels. The market price of wheat soon after the Agreement went into effect rose well above $2.00 a bushel, later going considerably higher, so that the importing countries benefited by the Agreement. The import quotas of many of them were promptly passed and the countries were no longer eligible to buy wheat at less than the market price.

Another form of agreement is one which arranges for import quotas with respect to imports into a principal consuming country, the quotas being allocated to the principal suppliers. Thus Great Britain made agreements allocating import quotas of beef to suppliers such as Argentina, Brazil, Australia, etc. The United States in the Inter-American Coffee Agreement allotted quotas to the principal Latin-American coffee exporting countries for the importation of coffee into the United States.

Commodity agreements are similar to cartels, discussed in the next chapter, but differ from the latter in that governments are parties to commodity agreements (although occasionally they participate in cartels), and in that commodity agreements ordinarily give attention, even though usually inadequate, to consumers' interests. Commodity agreements also apply primarily to foodstuffs and raw materials whereas cartels apply to manufactured goods.

The principal device employed by commodity agreements in the attempt to deal with surpluses and regulate prices is the quota. Quotas are usually applied to exports and are therefore to be enforced by the exporting country. Import quotas, however, are not uncommon, particularly when an import market is to be divided among exporters. Enforcement responsibility in the case of import quotas rests on the importing country.

Quota arrangements often tend to freeze production and trade in fixed channels and to favor the high cost producers who would otherwise be likely to be eliminated. Such arrangements ordinarily make no provision for the shifting of resources into other lines of production and away from high-cost areas, thereby endeavoring to reach the source of the difficulty. On the contrary, the quota system may prevent such adjustments by providing artificially high prices. Effective arrangements to encourage the shifting of resources are of course not easy to devise under a quota system. The low-cost producers, with their sales limited by the agreement, may sooner or later feel that they would fare better under free competition and may withdraw from the agreement. Such agreements thus have a tendency to break down.

Buffer Stock Plans.—The prices of agricultural and other primary commodities are particularly unstable and fluctuate widely in response to changes in demand and supply forces. Schemes have therefore been devised for the establishment of what are known as buffer stocks of certain commodities to serve as stabilizers of their prices. According to such a plan in periods of surplus production additions are made to the buffer stock, whereas in periods of scarcity supplies from the accumulated stock are supposed to be released to the market. According to price analyses most of the fluctuations in raw material prices under reasonably normal conditions are of a kind which could be offset by fairly small withdrawals from or additions to a buffer stock, so that an economic basis for such plans exists.

Buffer stock plans, however, have several rather serious difficulties. In the first place, storage costs and technical storage problems make the plans either impractical or very expensive for

certain commodities, e.g., relatively perishable commodities, those which require expensive storage facilities, or those which must be continually rotated. Another difficulty has to do with the determination of the proper prices at which to accumulate supplies and at which to release supplies to the market. Permanent changes in demand and in supply, new uses, new sources of supply, technological improvements in production, price-level movements and other factors make difficult an accurate determination of an equilibrium price and of the deviations therefrom which are to be compensated. Long-run price changes must be distinguished from short-run changes that will eventually balance each other.

An approximation to an appropriate price, however, with occasional corrections, might be determined were it not for a serious practical difficulty. This difficulty is the administrative problem of resisting pressure from interested groups and of maintaining a policy of prices, purchases, and sales based solely on economic considerations. This seemingly insoluble problem is the rock on which government purchase and storage schemes commonly founder.

Under pressure from interested groups administrators fail to distinguish between a temporary surplus which can be compensated and a permanent and chronic surplus which should not be continuously accumulated. Supplies are readily added to the stock so as to raise the price, but rarely are supplies released to the market, with a reverse effect upon the price. Even though it is impossible to determine accurately an equilibrium price for a commodity, enough statistical and economic information is available so that, for certain commodities, where storage is feasible, a buffer stock arrangement could yield reasonably satisfactory results were it possible to assure an independent and competent administration of the plan. The likelihood of such an administration appears to be so slight that buffer stock plans have little attraction as a solution to commodity instability.

Commodity Agreement Safeguards.—While experience shows that commodity agreements in practice tend to be restrictive, to reduce production and trade, and to be harmful to

consumers' interests, this fact does not deny the existence of a problem with respect to certain basic commodities. In view of the fact that governments are not going to be deterred from unilateral measures in behalf of certain commodities, the alternative to commodity agreements is uncoordinated and uneconomic plans.

Independent national actions on behalf of a commodity have usually led to further distress at home and abroad, and sooner or later break down of their own weight. In the case of commodities with an international market, control arrangements, if they are to hope to succeed, should be on an international scale and conform to certain standards.

If commodity agreements are to rest on reasonably solid ground they should avoid uneconomic and restrictive procedures, and seek to remedy the underlying conditions which led to the surplus. They should facilitate production by the low-cost areas, encourage a shift of resources out of surplus production and into other lines of activity, assure the establishment of prices which recognize consumers' interests, and promote arrangements in general which are in harmony with an expansion of world trade. They should facilitate an increase of consumption rather than be content with price supports or similar palliatives. The fact that these goals do not appear likely to be attained casts doubt on the usefulness of commodity agreements. On the other hand, since the alternative to commodity agreements is uncoordinated national schemes, and since with or without the United States commodity agreements are likely to be entered into, this country has participated in agreements and thrown its influence on the side of appropriate safeguards and standards. Perhaps with the passage of time commodity agreements can be brought more into harmony with economic objectives. The Wheat Agreement has gone a considerable distance in this direction.

The charter of the proposed International Trade Organization (not accepted by the United States Congress), makes provision in Chapter VI for international cooperation with respect to the regulation of commodities, and establishes certain safeguards and standards for commodity agreements. These include provisions for publicity regarding the agreement and its

operation, and "adequate participation of countries substantially interested in the importation or consumption of the commodity as well as those substantially interested in its exportation or production." The charter endeavors to balance voting power evenly between the two groups. Commodity control agreements may be entered into by members of the Organization only when a finding has been made through a commodity conference or through the ITO that certain conditions of surplus exist. These charter provisions or ones similar to them, if they were to be implemented would afford considerable protection against the abuses to which commodity agreements are commonly subject.

International Aspects of United States Agricultural Policy.—The United States Government's agricultural policy has, since 1933, involved government support of the prices of an increasing number of farm products at higher levels than would otherwise have prevailed. The aim has been to increase the income of the American farmer. This policy has important international aspects. The United States price support program is based to a large extent on the principle of "parity" prices, which are those which make the relationship between the prices of agricultural commodities, which farmers sell, and those of manufactured and other commodities which farmers buy, the same as in the base period, August, 1909, to July, 1914, as adjusted. Through direct government purchases and through nonrecourse loans on the farm products supported, the prices of these products are maintained at a certain percentage of parity, commonly up to 90 per cent of parity. When a loan matures farmers customarily exercise their right of not repaying the loan, and instead surrender the commodity which was given as collateral since the loan price is above the market price. The farmers thus do not wish the commodity returned but prefer to forfeit it.

This price support program has resulted in large accumulations of surplus stocks of commodities by the Government's Commodity Credit Corporation (CCC), at a cost of several billion dollars. Price supports usually encourage excess production of the commodity in question and become costly to the

government. In an effort to facilitate adjustments of output to demand, and to avoid surpluses, the United States has undertaken to a certain extent to apply acreage allotments, which restrict the acreage which a farmer may plant, and marketing quotas, which limit the amount of the commodity he may sell. Such measures are essential if the cost of the program to the government is to be kept within bounds and if prices are to be effectively stabilized.

This country's agricultural policy has important effects upon other countries. The United States regularly exports and imports large amounts of agricultural products. In 1950 the United States exported about 49 per cent of total world cotton exports, about 39 per cent of world wheat exports, and about 41 per cent of world tobacco exports. About 28 per cent of the world's sugar exports and about 21 per cent of wool exports came to the United States in 1950.

An artificially high price of farm products which are exported raises their cost to foreigners and tends to reduce foreigners' real incomes. It also encourages foreign production, which is frequently inefficient, and leads to the use of substitutes. A United States price which is raised above the world price attracts imports into the United States, and tends thereby to defeat the domestic program, unless the United States wishes to support the world price. In order to prevent large imports the government therefore has imposed import quotas, and embargoes. A price support program also discourages exports because of the high United States price, and leads to export subsidies, or to government sales abroad at lower prices in order to liquidate government stocks. The United States foreign aid program has contained special provisions designed to reduce United States agricultural surpluses resulting from price supports.

The international effects of price support measures are illustrated by this country's experience with respect to cotton. During the 1930's the United States raised the domestic price of cotton through acreage restrictions and nonrecourse loans based on support prices higher than those in the world market. The high domestic prices of cotton soon reduced cotton exports

substantially and resulted in accumulations of surplus cotton within the United States. Foreign countries, however, expanded their production of cotton, aided by the reduced amount of American cotton sold on the world market. In order to enable United States growers to sell their cotton abroad, export subsidies were paid beginning in 1939. The war and postwar strong demand for cotton and other agricultural products relieved this country of its excessive accumulations. As world production and consumption returned to more normal levels, the surplus problem reappeared. Defense needs, however, following the invasion of Korea, again relieved the problem.

In order to dispose of large accumulated stocks of commodities the CCC offers certain commodities to exporters at prices below their cost, which practice is disliked by foreign countries. However, inasmuch as the prices at which these commodities are offered are ordinarily not greatly below world market prices the repercussions have not been very serious.

To prevent imports of commodities whose prices are supported by the United States from interfering with domestic prices and from reducing the effectiveness of the program, annual import quotas have been enforced on wheat, wheat flour, cotton, etc. Imports of butter have been completely prohibited by the United States, and other imports have been licensed and the quantities restricted. The government moreover, has the authority to impose import fees on the import of commodities if their importation would interfere with the program.

While the effects of this country's agricultural program upon its foreign trade do not appear to have been particularly great from the quantitative standpoint, insofar as they can be identified, the program has a close relation to this country's foreign economic policy and to its efforts to promote an expansion of world trade on a liberal, nondiscriminatory and multilateral basis. The international aspects of the agricultural program are in fact extensive and important and are not measured by the quantitative effects upon the flow of trade which can be immediately identified. The United States has opposed other countries' actions with respect to such things as export subsidies, government sales abroad at less than market prices

(dumping), the imposition of import quotas and fees, and other types of restrictions on trade. The United States objects to such devices in principle, except under special circumstances, which do not, however, include all of those under which the United States has employed these devices. This country's agricultural policy involves certain inconsistencies with its general economic foreign policy as discussed in Chapter 34. The United States, moreover, is becoming increasingly an importer of raw materials so that restrictive and price raising commodity schemes, which are encouraged elsewhere by the United States agricultural policy, are contrary to this country's interest, apart from their uneconomic aspects.

The United States has recently been endeavoring to bring its agricultural policy into closer harmony with its foreign economic policy. Emphasis by the United States upon stable and adequate agricultural incomes, achieved through such measures as special subsidies, rather than emphasis upon high prices for farm products, would be more in line with this country's fundamental economic objectives.

Chapter 33

CARTELS

Nature and Development of Cartels.—In international trade, as in domestic trade, businesses are constantly seeking means of maximizing their profits. While competition, a main feature of the free enterprise system, keeps businesses alert to attain greater efficiency and more effectively to meet the desires of consumers, it also tends at times to limit their profits. It is not unnatural therefore that producers and exporters in different countries should seek means of reducing or eliminating competition between them, and should develop special arrangements to this end. The support of government, where possible, is often enlisted by businesses in their endeavor to reduce competition from other countries. In periods of surplus production, whether due to depressed markets, crop variations, or to the slowness with which producers adjust themselves to new situations, the incentive for producers to limit competition is especially strong. However, periods of surplus are not essential to the existence of efforts to restrict competition and to seek monopoly profits.

One of the means by which businesses have sought to restrict competition is through cartels. The word "cartel" is frequently used in different senses, which is the source of confusion. In the United States it carries the connotation of an undue restraint of trade and of abuses, whereas in Europe the word has referred merely to a particular type of business association, with little or no implication of improper activities. In American usage a cartel is similar to a trust or a monopoly, and is generally regarded as an improper business arrangement. The present European attitude, however, is tending toward that of the United States. In any event a cartel is an association of

businesses for the purpose of fixing prices or terms of sale, limiting output (usually by means of quotas), dividing markets, and making other arrangements in the interests of the participating businesses. The association between businesses may be a formal one based on written agreements or it may be merely a loose verbal understanding. A cartel may embrace only domestic businesses, but ordinarily the word refers to an international cartel, which includes businesses in different countries. In the United States an association of businesses is not generally considered a monopoly or a cartel unless the purpose to be served is such restraint of competition as is considered improper or illegal.

The restrictions upon production and trade that are imposed by a cartel may similarly be imposed by a large single enterprise. When a group of companies in different countries unites and forms a single company, with branches, subsidiaries or affiliates, the result is referred to as a combine.

Cartels have a history that goes back several decades. The growth and expansion of cartels, however, took place particularly during the period between the first and second World Wars. After the first World War many large businesses were confronted with excess capacity and consequent keen competition. The period was one of expansion in production and trade and saw the consolidation and concentration of industries into fewer and larger units, both in Europe and in the United States. After the war many of the prewar foreign subsidiaries of German businesses were acquired by United States or British companies which proceeded to develop cartel arrangements with the former German parent company. These arrangements were often encouraged by the need of the new owners for the technical knowledge and experience of the parent company.

The depression of the thirties brought everywhere a movement away from competition as a regulator of output and prices, particularly in the international field, and substituted the machinery of negotiation, in which governments frequently participated. In the international field the machinery for such negotiation, especially in Great Britain, was frequently the trade association or an export association. In the United States the

Webb-Pomerene Act of 1918, noted below, permitted American businesses to combine into selling organizations for purposes of foreign selling. Accompanying these developments during the 1920's and 1930's was a rapid growth throughout the world of international cartels, in which United States businesses became active participants.

Cartels are in many respects not unlike commodity agreements, already discussed, in that their objectives have been to a large extent similar. The two forms of agreement have in fact sometimes been indistinguishable from each other. They both have sought to control the production, price, or distribution of a commodity, and have been designed primarily, or exclusively in the case of cartels, for the benefit of producers. Commodity agreements, however, differ from cartels in that governments are commonly parties to the agreements (although governments in some instances participate in cartel arrangements), which fact permits recognition of consumer interests and the representation of countries that are predominantly importers of the commodity in question. Commodity agreements thus give attention to the interests of consumers, even though this attention is usually not very great. Commodity agreements, like cartels, have, in fact, generally emphasized producer interests. The recognition of consumer interests is, nevertheless, considered a distinguishing feature of commodity agreements. Commodity agreements are applied principally to foodstuffs and other basic commodities whereas cartels are applied to manufactured goods. The producer interests to which cartels cater thus ordinarily represent fewer persons than do the producer interests benefited by commodity agreements. Agricultural producers, for example, and persons dependent on agriculture for their incomes represent in most countries a larger section of the country's population than do the owners of steel or chemical plants and persons dependent on such plants.

Whether a particular commodity is controlled by means of cartel arrangements or by a commodity agreement is related to the nature of the commodity. Raw materials and basic foodstuffs are controlled, in cases where such controls exist, by

intergovernmental commodity agreements. Commodities that are or have been subject to such agreements include rubber, tin, nitrates, oil, copper, coffee, tea, cocoa, sugar, wheat, etc. Controls exercised over highly processed products, on the other hand, are almost entirely of a private nature. Products subject to private controls, i.e., cartel arrangements, include steel, pharmaceuticals, chemicals, electrical goods, and optical glass. In the middle area, including such articles as steel rails, cement, paper, etc., the controls thus far have been largely private, although governments have shown an increasing tendency to participate in some degree in the arrangements. The United States Government has not participated in cartel arrangements, as have European governments, but is a participant in various commodity agreements, especially those dealing with agricultural commodities.

An early example of efforts to control a raw material in the interests of producers, and which illustrates many of the inherent problems in cartels and commodity agreements, was the unsuccessful attempt of Great Britain in 1922 to control the price of crude rubber. For many years rubber was obtained almost exclusively from the natural rubber forests of Brazil. During the early part of this century, however, large cultivated rubber plantations were developed in the Malay Peninsula and the Dutch East Indies. The rubber plantations grew so fast that the price of crude rubber fell from over \$2.00 per pound in 1910 to fifteen cents per pound in 1921. In an attempt to raise rubber prices, Great Britain inaugurated the so-called Stevenson plan whereby exports of crude rubber from British territory were regulated by means of a sliding scale of export taxes, the taxes increasing with the volume of exports. The endeavor was to raise prices of rubber by discouraging exports. During the time the program was in effect, rubber prices fluctuated widely. Increasing to over thirty cents per pound in 1923, the price dropped to eighteen cents in 1924 and then rose to over a dollar per pound in 1925. In 1926 the price fell to less than forty cents per pound and remained at approximately this level during 1927. In 1928 the export tax on rubber was removed and the attempt at price control abandoned.

The program was suspended for several reasons. In the first place Great Britain did not control the entire supply of crude rubber, and the large Dutch rubber interests in the Dutch East Indies were glad to see exports from British territory reduced so that they could sell all the more, and at the improved prices. Moreover, the United States, the principal consumer of rubber, was displeased over the plan to raise prices and curtail exports, and began to develop its own sources of rubber. The plan emphasized to the United States that one of the vital raw materials which it lacked could be manipulated by a foreign power to this country's harm. The United States, therefore, undertook to develop rubber plantations of its own in Africa, Brazil, and other parts of the world. Insofar as the program succeeded in raising prices, it created ill-will, and threatened to cut off large markets in the United States and elsewhere.

The effects of the Stevenson plan were not confined to the period during which it was in effect. The high rubber prices which it encouraged resulted in the planting of extensive new rubber acreage in non-British possessions as noted. Since a period of five years must elapse between planting and commercial exploitation, the effect of the increased acreage was not serious until the time of the world depression when, as a result of the increased supply and reduced demand, the price of rubber fell to three cents a pound.

Cartel Methods.—Cartel agreements generally provide for the fixing of prices, a division of markets among the different producers, limitations on output through quotas assigned to the different producers, or other restrictions on operations. Numerous variations in the arrangements exist, but practically all the provisions are directed toward the restriction of competition and the raising of prices.

A common procedure, probably the most common by which cartels restrict competition, is the assignment of certain areas to certain producers who thereby enjoy the exclusive right to produce and sell in those particular areas. In some areas joint operations are undertaken in which case quotas are assigned to the different producers. For example, in the complaint of the

United States Department of Justice against Imperial Chemical Industries (ICI), E. I. du Pont de Nemours & Co., and others, it was charged that the entire British Empire, except Canada and Newfoundland, was assigned exclusively to ICI, and that the United States and Central America were assigned exclusively to du Pont. Moreover, both these companies had agreements with the German firm I. G. Farbenindustrie, whose tentacles seemed to reach everywhere, as well as with other chemical producers. ICI and I. G. Farbenindustrie apparently had working arrangements regarding the production and sale of specific products. Operations of cartels, especially in third countries, are sometimes conducted through subsidiaries jointly owned. Thus du Pont and ICI ceased competing in Canada when they established there the jointly-owned Canadian Industries, Ltd., which became the exclusive manufacturer and importer in Canada of the products of both companies. They also jointly own Duperial Companies, which in Latin America manufactures and imports the products of both companies.

The operations of the European nitrogen cartel also illustrate cartel methods. This cartel was formed in 1938 and included Imperial Chemical Industries, the Solvay Company of Belgium, the marketing organization of I. G. Farbenindustrie, known as Stickstoff Syndikat, the Chilean Nitrates and Iodine Sales Corporation (through its London subsidiary), and various other producers. After the formation of the cartel, European exports of nitrates to the United States and Egypt were sharply curtailed, these markets thereafter being supplied by Chile. Similarly, Chilean exports of nitrates to Europe were sharply reduced. During the war the demand for nitrates was great and productive capacity was expanded. The principal reason for the existence of the cartel, namely the former excess capacity, was no longer present and the cartel ceased to function.

Cartel arrangements frequently center around the interchange or pooling of patents or technical processes and thus have a special legal basis. Patents provide the exclusive right to manufacture and sell articles patented or to license such manufacture or use, and therefore can readily be used to restrict competition and divide markets. Cartel arrangements based on

patent rights may be enforced by appeal to governmental authority. Agreements based on patents and technical processes constitute a customary vehicle for restrictive arrangements in industries that produce highly processed articles. The agreement noted above between Imperial Chemical Industries, du Pont, I. G. Farbenindustrie, and others centered around an interchange or pooling of patents and processes.

A further example is the agreement between General Electric Co. and Krupp. In 1928 these companies entered into an agreement to pool their patents relating to the production of tungsten carbide, a metal used for hard tips on machine tools causing them to retain their sharpness, a matter of importance to industry. According to the agreement, General Electric was to fix the price at which tungsten carbide was to be sold in the United States, and also was required to license the production and sale at this price by firms formerly licensed by Krupp. Krupp was to receive royalties on all sales of tungsten carbide by its licenses and by General Electric. Krupp was not to sell in the United States except at the fixed prices. After the agreement went into effect the price was raised sharply from about $50.00 a pound to about $453.00 a pound, with a lower price to large purchasers. The agreement was subsequently altered whereby Krupp agreed to withdraw from the United States market and would receive larger royalties from sales by General Electric. The consumption of tungsten carbide in the United States did not keep pace with that in other manufacturing countries during the period the agreement was in force, which fact was apparently due to some extent to the high price.

Another agreement based on patents was that made in 1929 between I. G. Farbenindustrie and the Standard Oil Company of New Jersey. The agreement pooled certain patents and processes and allocated to I. G. Farbenindustrie for use anywhere in the world the pooled chemical patents and processes, and to the Standard Oil Company the patents and processes relating to oil for use anywhere except within Germany. I. G. Farbenindustrie thus continued to exercise control over its chemical processes in the United States market. Through this agree-

ment Germany obtained access to United States discoveries regarding oil processes.

Economic Effects of Cartels.—International cartel arrangements, to the extent that they are effective, usually restrict output, raise the prices of products sold under the cartel arrangements, and reduce the volume of international trade from levels which would otherwise prevail. A member of the cartel must, in varying degrees, export only at fixed prices, within quota limits, in a certain market or under other limitations. Such restrictions are contrary to the best interests of the consuming public and have little or no justification on economic grounds, unless perhaps they were to deal only with temporary surpluses and were accompanied by arrangements to facilitate fundamental adjustments in the use of resources as indicated by consumer demand on a relatively free basis. Cartels, however, are not of this nature, although under government supervision it is not impossible that they could be altered. In behalf of cartels it is sometimes said that they encourage abandonment of high-cost plants, and eliminate wasteful competitive practices. In actuality, however, it is doubtful whether such advantages are realized to a significant extent. International cartels are built on the basis of domestic cartels, which fix prices sufficiently high to provide for high-cost producers. Furthermore, a reduction of output may result in an increased unit cost. If there were an elimination of high-cost producers or of wasteful competitive practices, whatever gains arose would in any event accrue to the cartel and not be passed on to the public.

A higher selling price enforced by a cartel ordinarily affects both the total value and volume of sales of the commodity in question. The precise results depend in part upon the price elasticity of the demand for the commodity. In the case of inelastic commodities a higher selling price will cut off only a few sales, so that the volume of sales is well maintained and the total value of sales is probably increased. If the higher prices reduce sales materially, however, the total value as well as the volume of sales will probably be reduced, although it is

possible that the value may be maintained inasmuch as the smaller volume is sold at higher prices.

The extent to which net profits are increased, or perhaps decreased, by higher prices, depends also upon the price elasticity of supply, together with whether production takes place under conditions of constant increasing or decreasing costs. A change in the volume produced may raise or lower unit costs with consequent effects on profits. If the value of sales declines because of higher prices, profits will probably be less. However, even though the total sales value is less, profits are not necessarily less since, at the lower volume of sales, it is possible that unit costs have declined and may compensate for the reduction in the total sales value. If, on the other hand, a decline in volume, but not in total value of sales, raises unit costs it is possible that even though sales values may have increased, the rise in costs may offset the gains. The general principles applicable to cartel pricing are the well-known ones of monopoly price.

It can be seen that a cartel policy of restricted output and higher prices may yield little or no net gain to the members of the cartel, and that an expanded output, although sold at lower prices, would be more profitable to both producers and consumers. The available data are inadequate for a definitive conclusion as to the profitability of cartels, but it is sometimes believed that cartels have not gained greatly by their restrictive policies.

A further effect of cartels is that upon the balance of payments. A reduction in the value of exports of a commodity which is important in a country's foreign trade may reduce the supply of foreign exchange accruing to such country. The countries in which cartels exist and where they may depress exports are principally the industrialized countries of Europe. Japan has also been a country of cartels. Importing countries where imports of products sold by cartels would otherwise be larger, may as a result conserve foreign exchange, although this is accomplished at the cost of fewer and perhaps needed imports. The situation with respect to the balance of payments varies in particular cases, but a narrowing of international trade and a reduction in its responsiveness to competitive forces usually is harmful to equilibrium adjustments in the balance of payments.

Cartels are frequently formed as a result of problems of surplus capacity, as already noted. During the 1920's the excess capacity which followed the wartime expansion, especially in the heavy industries, was a factor in the formation of the European steel cartel. During the 1930's the depression and curtailed markets provided an incentive toward cartelization as a means of reducing the pressure on prices from surplus or idle capacity. The problem of stabilization for manufacturing industries is in many respects not unlike that confronting producers of primary commodities, and for which problem a solution is sought through commodity agreements. Cartels have thus arisen partly in response to a condition of industrial maladjustment. The solution, however, which industry has attempted to apply through cartels has fundamental economic difficulties, and is more in the nature of a palliative than a remedy of causes.

A large amount of the world's trade, perhaps nearly half, is subject to cartel agreements to a greater or less extent. There is no precise answer as to the degree to which cartels and their restrictive practices alter the results which would have been produced by competition in such matters as price, quality, technology, economic stability and the adjustment of capacity to demand. In this connection Professor Mason of Harvard has said it is his opinion "that the injury inflicted by tariffs on domestic competition and American foreign trade has been several times greater than the effect of cartels; that current agricultural policy is likely to be much more damaging to exports than the total of American cartel practices; that intergovernmental commodity agreements will reduce the volume of postwar world trade more drastically than international cartels; and that the problem of dealing with state trading monopolies will far overshadow the difficulty of dealing with cartels.

"This judgment does not deny the importance of the international cartel problem." [1]

Governmental Policy Toward Controls.—The question arises as to what is an appropriate policy with respect to cartels and restrictive business practices. Should the effort be to elimi-

[1] Edward S. Mason, *Controlling World Trade* (New York: McGraw-Hill Book Co., Inc., 1946), p. 28.

nate cartels entirely, or should it be to limit and regulate their activities in the public interest? One line of reasoning would say that cartels and their restrictive practices represent a departure from competition and a free enterprise economy, and are therefore fundamentally contrary to the public interest; governments should prohibit or curb them and endeavor to enforce competitive conditions of production and sale in the interests of lower costs and more efficient production and utilization of resources. On the other hand, not everyone agrees with the advantages of competition. A number of governments prefer that production and trade be conducted by negotiation rather than by competition. They favor large industrial units and are not concerned about monopolistic arrangements or restrictive practices.

Another line of argument is that concentration of industry has come to stay, regardless of relative merits; that a large amount of trade will continue to be conducted through state trading agencies or through private agencies or associations with active state participation, and that cartel arrangements are therefore necessary in order that enterprises may obtain their share of business under such conditions. It is urged therefore that governmental policy, particularly of the United States as the principal opponent of cartels, should adapt itself realistically to conditions as they exist and endeavor to regulate cartels with the aim of avoiding abuses and uneconomic practices insofar as possible rather than attempt to abolish them.

The United States has achieved its great advancement under the system of free enterprise wherein competition is a driving force. In view of its belief in the free enterprise system, the United States endeavors to enforce reasonable competition and in several instances has broken up monopolistic enterprises into smaller units. The United States seeks to maintain competitive conditions wherever feasible, and if not feasible, as in the case of public utilities, to regular monopolistic enterprises in the public interest. Monopolies are dealt with by the Sherman Anti-Trust Act, the Clayton Act, the Interstate Commerce Act, etc.

An early departure from the United States effort to maintain competition was the Webb-Pomerene Act of 1918 which was

designed to aid American companies in competing with foreign cartels. The Act provides exceptions to anti-trust legislation prohibiting monopolies and practices in restraint of trade, and permits businesses to combine into selling associations in connection with foreign sales. Exporters may form associations which are under the general supervision of the Federal Trade Commission. A large number of such export associations have been formed but only about fifty are in active operation.

The original impetus behind the Webb-Pomerene Act was to aid American small businesses against cartels and against large domestic businesses. Some of the present associations, however, include large businesses well able to take care of themselves at home or abroad. The Act does not permit the associations to restrain trade within the United States, but it appears that such associations have in some instances been used to restrain domestic competition among members, to limit imports into the United States by agreements with foreign businesses and to harm businesses outside the association. Attempts to limit competition in foreign trade, putting up a common front to the foreigner, but maintaining competition domestically among the same firms, involve difficulties. Nevertheless, in view of the prevailing method of conducting world trade in most countries, there is much to be said for the export association under proper control.

The weight of evidence, according to the United States view, favors a policy of endeavoring to eliminate the undesirable practices of cartels rather than of seeking to destroy the cartel itself. However, if the undesirable practices are eliminated there is not much left of the cartel. Cartel arrangements, since they apply to manufactured articles, do not lend themselves to governmental supervision or determination as readily as do similar arrangements applying to agricultural and other basic commodities, as provided in commodity agreements. Standard or graded articles like sugar, wheat, or cotton offer fewer complications for international agreements than do manufactured products in which variations may be great. Government participation in the details of cartel arrangements is in general, therefore, less feasible in commodity agreements. Furthermore, the number

of people dependent upon the price and market for a particular agricultural commodity is ordinarily greater than those dependent upon a particular manufactured article, so that the public interest, especially on the producers' side is likely to be broader in the case of commodity agreements.

Cartel arrangements have certain security aspects, although this problem has at times been overemphasized. Much discussion took place after the second World War regarding the use Germany had made of her cartel connections to further her program of aggression, not only in obtaining technical data of strategic value but particularly as a means of foreign penetration and of influencing the course of economic and political affairs in foreign countries. The large German cartels actively supported the Nazi government and materially aided its aggressive program. Cartels in Germany had been an integral part of the governmental machinery. It was therefore urged after the war that German cartels and combines be broken up as a security measure. The fact, however, that they actively supported the government and were one of the tools of aggression, was due not so much to the inherent nature of a cartel as to the nature of the German government and the aggressive and militaristic philosophy behind it. Almost any institution, national or international, can be subverted to improper purposes. This fact, of course, does not mean that cartels are harmless, but that the case against them is to be considered primarily on economic and commercial policy grounds rather than on those of security.

The German cartels exemplified practically all the undesirable aspects of cartels. Their policies and practices, although supported by the government, were restrictive and contrary to the interests of the general public. The policy of the United States in its occupation of Germany was to break up the combines into smaller units. Similarly in Japan the policy of the United States was to break up the Japanese cartels or Zaibatsu as they are called. France and Great Britain, however, disagreed with the United States as to the dissolution of the cartels. Great Britain's labor government favored nationalization of industries and was opposed to decartelization, believing that the

existence of cartels would facilitate government ownership and operation. France, on the other hand, desired a large number of minor concerns, especially in the field of steel and coal production, which would be weak and deter any possible revival of German military strength.

In the so-called "Schuman Plan" for the integration of the coal and steel industries of Western Europe, sponsored by France and favored by the other countries, although with some hesitation by the United Kingdom, the United States, while approving the effort in the interests of efficiency and closer economic relations, was concerned that cartel features be avoided insofar as possible. The Schuman Plan, subject to ratification by the six countries involved, France, Belgium, the Netherlands, Luxembourg, Italy, and Western Germany, provides for an over-all international authority to integrate the production and sale of coal, coke, iron, and steel. It seeks to open up a single market in Western Europe for these products on a competitive basis, in place of the previously existing national or compartmentalized markets. Adoption of the plan was complicated by opposition created by the measures that were undertaken toward the decartelization and deconcentration of German coal and steel monopolies, especially the DKV, which is the Ruhr sales organization that for fifty years has had a monopoly of the sales of Ruhr fuel. The Germans desired to retain the DKV. However, these problems were finally resolved and all the countries agreed to satisfactory anti-cartel provisions.

The combination of cartels and government-owned industries, or the substantial participation of governments in industries, raises special questions regarding cartel policy. The relation of cartels to general security and international political affairs has to do particularly with the fact that governments today participate actively in industry and trade. A country's commercial operations in foreign countries and its government's foreign policy are thus considerably interwoven. A government's intervention in cartel arrangements and its support for particular cartel activities, are not unrelated to such government's foreign policy. The need for intergovernmenal agree-

ment on cartel policy and on regulation thus becomes apparent.

The desirability of international regulation of cartel arrangements has been widely accepted, and such regulation was provided for in the proposed Charter (not accepted by the United States Congress) for an International Trade Organization. Chapter V of the Charter entitled "Restrictive Business Practices" provided as follows:

GENERAL POLICY TOWARDS RESTRICTIVE BUSINESS PRACTICES

1. Each Member shall take appropriate measures and shall cooperate with the Organization to prevent, on the part of private or public commercial enterprises, business practices affecting international trade which restrain competition, limit access to markets, or foster monopolistic control, whenever such practices have harmful effects on the expansion of production or trade and interfere with the achievement of any of the other objectives set forth in Article 1.

2. ... complaints regarding any of the practices listed in paragraph 3 shall be subject to investigation....

3. The practices referred to in paragraph 2 are the following:
   (a) fixing prices, terms or conditions to be observed in dealing with others in the purchase, sale or lease of any product;
   (b) excluding enterprises from, or allocating or dividing, any territorial market or field of business activity, or allocating customers, or fixing sales quotas or purchase quotas;
   (c) discriminating against particular enterprises;
   (d) limiting production or fixing production quotas;
   (e) preventing by agreement the development or application of technology or invention whether patented or unpatented;
   (f) extending the use of rights under patents, trade marks or copyrights granted by any Member to matters which, according to its laws and regulations, are not within the scope of such grants, or to products or conditions of production, use or sale which are likewise not the subjects of such grants;
   (g) any similar practices which the Organization may declare, by a majority of two-thirds of the Members present and voting, to be restrictive business practices.

The emphasis in the Charter, it will be noted, is placed upon undesirable practices rather than on the cartel itself, although, as noted above, the two are hardly distinguishable. The activities of a combine are thus also provided for. The Charter

provided for consultation and also for complaints by any member regarding the existence of a practice which has the effects mentioned in Paragraph 1. The Organization could investigate a complaint, arrange for hearings, recommend remedial action, and require a report on actions taken. The Charter provisions, which were drafted by representatives from fifty-seven nations in numerous sessions and after lengthy debate, would doubtless have accomplished considerable in eliminating the principal harmful aspects of cartels. They may yet form the pattern for some type of international control of cartels.

Chapter 34

UNITED STATES FOREIGN ECONOMIC POLICY

Objectives of United States Foreign Economic Policy.—The distinction between domestic and foreign economic affairs is no longer clearly defined. Many policies and actions which are commonly regarded as essentially domestic have significant international consequences, and conversely, activities which are usually considered primarily of an international nature may have important domestic repercussions. For example, a subsidy to the domestic producers of an article which has an international market may affect the prices and amounts offered in the international market, with important consequences in a number of countries. Similarly, a country's monetary and fiscal policy and efforts to prevent unemployment almost inevitably affect its foreign trade, balance of payments, and relations with other countries. An exchange rate adjustment may have repercussions on the domestic affairs of many countries.

As domestic and international economic affairs have become increasingly interwoven, similarly have international economic and international political affairs become interwoven. There are few policies and actions of governments today which, if not predominantly economic in nature, do not have important economic aspects. For example, the European Recovery Program, and the North Atlantic Treaty combine both political and economic factors. Foreign economic policy is thus an integral part of and inseparable from over-all foreign policy.

The close interlocking of international economic and political affairs and their relation to domestic affairs are reflected in the conduct of United States foreign affairs. The various agen-

cies of the government increasingly participate and assist the Department of State in the formulation and carrying out of the foreign policies and activities of this government, as noted below.

In view of the leading position which the United States occupies in world affairs, the foreign economic policy of this country plays a special role in the shaping of international economic relations and in the determination of the kind of economic system or systems which prevail in the world.

The ultimate objectives of United States foreign economic policy are simple. They can be set forth under a number of headings but are essentially: (*a*) Maintenance of peace on a basis of free democratic institutions and within an international structure which promotes orderly international relations—not a purely economic goal but one which requires extensive support from economic measures, and which in recent years has demanded priority over other goals; (*b*) expansion of production and attainment of high and rising standards of living, not only for the United States but for foreign countries as well, especially underdeveloped areas where living standards are extremely low; (*c*) prevention of economic instability and disturbances which may lead to depression and unemployment. These goals, all interrelated, vary from time to time in their urgency and the amount of attention each demands. It is hoped that eventually the main effort can be directed toward the second goal of advancing living standards, because the other two shall have been largely achieved.

The above goals are of a kind over which there can be little dissent. The methods by which they are to be attained, however, and determination of the type of economic organization which will contribute most effectively to their realization, raise a number of questions. These questions, both practical and theoretical, are of a kind which require decisions.

Free Enterprise, Multilateralism, and Nondiscrimination.—The foreign economic policy of the United States is based on the fundamental premise that the goals sought can be realized most effectively through the system of free en-

terprise and free markets, subject, of course, to necessary controls. It is under this system that the United States has achieved its great advancement, and is continuing to expand in unrivaled fashion its production and income, and to lift its living standards to new high levels. Practically all the advanced countries of the world have achieved their present status under the free enterprise, or capitalistic system, as it is often known. This system has historically been associated with certain evils, such as exploitation of labor and excessive privilege for a few, but under present-day controls and taxation is rapidly ridding itself of these attributes. The name "capitalism" has come to be associated with the abuses, with wealth and poverty, and is a word of condemnation. Belief in the advantages of the free enterprise or capitalistic system is often taken, as a result of this association, to imply a condoning of the evils which are today largely no longer present, at least in their former extent.

The problem of economic organization has been to devise means of retaining the advantages of the free enterprise system —such as the gains in output which come from reasonable freedom permitted private initiative and competition and which come as a result of the automatic rewards for skill in meeting consumers' desires economically and effectively, and the advantage of personal freedom and opportunity to earn a living wherever and in whatever manner is desired—and at the same time to curb excesses and protect workers and the public against unfair tactics and improper activities. Appropriate controls strengthen the system and increase its advantages, whereas excessive and uneconomic controls stifle it.

The accumulation during recent years of numerous regulations and controls raises the question of how much is left of free enterprise with its free market mechanism. In the field of international economic affairs, regulations and restrictions are frequently of a nationalistic nature and of a kind which tend to impede operation of the free enterprise system. They frequently have little or dubious economic justification, even from the standpoint of the nation imposing them, although they may benefit certain groups within such nation. Tariffs, quotas, exchange restrictions, bilateral trading arrangements, licensing

requirements, cartels, and other discriminatory devices have been piled onto trade, especially during the past decade or two, until trade is confronted with barrier after barrier, is narrowed and shunted into uneconomic channels. In the United States where trade flows internally over a large area with little or no interference, production and living standards have moved upward rapidly. There appears little doubt but that the pace of expansion in the United States is more rapid than if this country were broken up into compartments separated by tariffs and other restrictions. In appraising the desirability of controls, however, it is necessary to take into account certain intangibles and the fact that national objectives are not always measured solely in terms of an expansion of production and the most economic allocation of resources.

In contrast to United States adherence to the advantages of free enterprise, and its desire to salvage as much of the free market mechanism as feasible, is the view prevalent in a number of foreign countries that socialism, or an approximation to it in the form of extensive government operation of productive facilities and fairly detailed control of economic life, can yield better results in terms of output, living standards, and equitable distribution of the product. While experience thus far does not give impressive support to this latter view, except perhaps during periods of temporary emergency, a large part of the world operates under socialistic or so-called mixed economies. How far to go in the direction of an administered or mixed economy is a problem confronting all governments. Which controls are "appropriate," and which ones "uneconomic" is a question not easy of determination. In all countries, including the United States, the participation of government in economic activities has increased greatly, but in the United States and elsewhere the underlying principle remains that of free enterprise.

Although foreign countries, particularly the underdeveloped countries, have had a deep-seated suspicion of free enterprise, this attitude has been changing. During the past few years there has been less confidence among these countries that government operation is the answer to their difficulties and the road to realization of their aspirations. The role that private enter-

prise can play in expanding production has been increasingly recognized.

The United States Government recognizes the right of a country to determine its own form of internal economic organization. In the field of international trade in cases where governments exercise close supervision over trade the United States believes that the interests of all countries will be served best if trade takes place as far as possible on the basis of commercial considerations in accordance with free enterprise principles. Government decisions with respect to the amount, nature, and direction of trade should, the United States feels, in general be guided by costs, prices, quality, etc. Otherwise, discriminations and political considerations are injected into transactions. In the absence of these standards trade is not likely to yield its maximum benefits for reasons discussed in other chapters. Furthermore, without such standards trade easily degenerates into economic warfare to a greater or less degree.

Along with the adherence of the United States to free enterprise this country believes that the world's trade should be conducted on a nondiscriminatory, multilateral basis free from undue restrictions. This is a cornerstone of United States foreign economic policy. Discriminations, bilateralism, and restrictions which are not warranted by special circumstances do not, according to the American view, permit production and trade to take place with the most effective utilization of resources and labor, and in conformity with consumers' interests which under free enterprise are freely expressed through the price system. Such measures interfere with the working of the principle of comparative advantage.

A policy which admits of numerous controls, discriminations, and bilateralism, however, is not without strong advocates, particularly in countries fearful of foreign, i.e., principally United States, competition. The argument is made that an adjustment in the balance of payments brought about through classical devices, such as devaluation or deflation, results in unemployment and reduction of incomes; similarly that competition and free markets bring deflation and unemployment, and that the United States economy is tied to the gyrations of the business cycle.

It is also said that the technological advancement in the United States and the high rate of investment there make it well-nigh impossible for other countries to compete successfully with the United States on a free market basis, and that discriminations are therefore necessary. It is argued, moreover, that if a country has a surplus in its foreign trade, other countries should be allowed to impose discriminatory import controls against the exports of the surplus country, since the imposition of general and nondiscriminatory controls would interfere with trade among the other countries and reduce total trade.

It is not possible to discuss here the weaknesses of these arguments, and the extent to which controls interfere with consumers' interests and the ability of the economy to produce new and better commodities, in larger volumes and with greater efficiency. The fallacies in these arguments, according to the American view, and the uneconomic nature of bilateralism and various restrictions on trade have been discussed in other chapters.

The United States foreign trade and exchange policy thus rests on the foundation of nondiscrimination, multilateralism, and a minimum of restrictions. The nature of those restrictions and regulations which may be necessary and justifiable cannot be stated with precision since they vary with circumstances. According to United States policy they should ordinarily be temporary, in the interest of the general public, do a minimum of harm to other countries, and not interfere unduly with an expansion of trade along economic lines. A legitimate restriction, for example, might be one on luxury imports during a period of exchange stringency, or a limitation of exports for security reasons. When during an emergency an article is in short supply and its production cannot or perhaps should not be readily expanded, price controls and rationing may be warranted in spite of their evils, provided appropriate measures are taken toward a fundamental solution of the problem.

Application of the classical principle of the free market, which underlies United States policy, in the world as it currently is organized and in the light of defense and other problems confronting it, requires a number of exceptions and recognition of

special situations. In view of the nature of the present-day world and the prevalence of central planning and national objectives of a noneconomic nature, rigid adherence to the free market principle is not feasible. It is to be noted that when countries follow policies of extensive internal controls and have widespread price and wage rigidities, the pursuance of liberal policies applied to external economic relations may lead to incongruities and difficulties. For example, under a planned economy exports may not provide enough foreign exchange to permit the elimination of quotas and other restrictions on imports, so that proposals for their elimination are in conflict with internal measures and policies. The United States and other countries do not agree on the role of the price system and other features of free enterprise. Efforts of the United States to obtain adherence to liberal trade policies can therefore be expected to continue to encounter difficulties.

The United States in its own laws and procedures departs from liberal economic policies not only domestically but in its international economic relations. The United States tariff, certain agricultural measures, and features of maritime policy, particularly cargo preferences, are examples. The Executive Branch of the government, however, has in recent years been making a special effort to remove any inconsistencies and to orient this country's foreign economic policies and activities more completely toward the attainment of a nondiscriminatory multilateral trading system with a minimum of restrictions.

The inconsistency, such as there may be, between United States international economic policies as sought by the Executive and also as supported by a large body of legislation, and certain other policies and actions rooted in legislation or desired by a strong minority (and in some instances based on Executive authority), is at times a source of embarrassment to United States officials in their negotiations with other governments. This situation, due to this country's democratic organization and to the separation of executive and legislative functions, is not always understood by foreigners. They often accept it, however, with good grace, due perhaps to the need for similar understanding of their own problems. It is well-nigh impossible for

a democratic country, with constitutional guarantees and restraints on the Executive, to have at all times a single unified and consistent foreign economic policy.

United States foreign economic policy is not a fixed and static policy, but one which changes with the times. The present policy has been developing for a long period of years, particularly since the inauguration of the Trade Agreements Program in 1934. The Communist attack on Korea and the rearmament program have not altered the long-range objectives, but have required to some extent a deferment of certain actions in order to give priority to defense needs.

The objectives of United States foreign economic policy have been stated officially on a number of occasions and in various forms. In addition to speeches and public utterances of State Department and other government officials this government has presented its views in the form of printed statements and has embodied them in laws, treaties, and agreements. The position taken by United States representatives in international conferences, at the United Nations, and in the specialized agencies reflects United States policy. The so-called Atlantic Charter, a joint statement issued in August, 1941, by President Roosevelt and Prime Minister Churchill, contains the following: The two countries "will endeavor . . . to further the enjoyment by all states, great or small, victor or vanquished, of access, on equal terms, to the trade and to the raw materials of the world which are needed for their economic prosperity;" [1] Article VII of the Lend-Lease Agreements between the United States and many other countries provided for action directed "to the elimination of all forms of discriminatory treatment in international commerce; to the reduction of tariffs and other trade barriers."

A more detailed statement of United States views on international economic policies was contained in a publication entitled "Proposals for Expansion of World Trade and Employment" issued by the State Department in 1945. These proposals formed the basis of negotiations for the projected but unrealized International Trade Organization discussed above.

[1] *Department of State Bulletin,* Aug. 16, 1941.

The joint statement by President Truman and Prime Minister Attlee in December, 1945, announcing plans for a United States credit to Great Britain, referred to the extended discussions that had taken place covering "long-range commercial policies in the broad sense embracing the fields of trade barriers and discriminations, policies in respect of commodities in world surplus, cartels, an international trade organization, and international aspects of domestic measures to maintain employment." It continued: "Both sides have . . . had continuously in view the common interest of their governments in establishing a world trading and monetary system from which the trade of all countries can benefit and within which the trade of all countries can be conducted on a multilateral, nondiscriminatory basis."

Implementation of United States Foreign Economic Policy.—United States foreign economic policy is given concrete expression in a number of ways. The United States has played an active part in the formation of various international organizations. In the drawing up of their charters the United States has sponsored principles which it believed would contribute most effectively to attainment of the purposes of the organization and the goals mentioned above. The Articles of Agreement of the International Monetary Fund thus state that one of its purposes is "To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade." The United States played a leading role in plans for such agencies as the International Monetary Fund, the World Bank, the proposed International Trade Organization (not accepted by the United States Congress), the General Agreement on Tariffs and Trade, the Food and Agriculture Organization, the Economic and Social Council of the United Nations, and a number of other agencies.

The purposes and policies set forth in the charters of international organizations are generally in harmony with United States views, although in some cases they are stated in a quali-

fied or weakened form. Moreover, these institutions at times interpret or implement their charter provisions in a manner which does not represent as vigorous an approach toward liberal trade policies as the United States would desire. Such policies are regarded by the representatives of some nations as "fine ideals," but "unrealistic" or "impractical." The United States therefore finds itself in these institutions and in international conferences frequently pressing for measures which it believes will facilitate trade expansion in the interests of all peoples, and opposing measures that are restrictive or in the interests of special countries or groups of persons. The basic cleavage is between the United States free enterprise approach, and the restrictive or controlled approach of central planning. Within the United States Government there are, of course, differences of views and varying degrees of enthusiasm for specific policies and their implementation. Nevertheless, this country's underlying policies as noted continue to guide its day-by-day actions.

United States policies also find expression in the negotiation of treaties and agreements. This country's treaties of Friendship, Commerce and Navigation, or Friendship, Commerce and Economic Development, as the more recent ones are sometimes called, endeavor, among other things, to promote adherence to the kind of policies noted. They also seek national treatment, insofar as feasible, for United States citizens in foreign countries, and fair compensation for properties taken by the government.[2] The treaties are on a mutual basis and the United States does not ask for what it is not prepared to give.

The United States Trade Agreements program, which succeeded in lowering the tariffs of many countries, and sponsorship by the United States of the General Agreement on Tariffs and Trade (GATT) as well as sponsorship of the unrealized International Trade Organization, represent special efforts by this country to attain major economic policy objectives.

Similarly, the Technical Cooperation Program, or "Point Four" as it is frequently known, represents actions to imple-

[2] See Chapter 31.

ment the United States policy of aiding the economic development of underdeveloped areas. This program, discussed in Chapter 30, was commenced in 1950 as an enlargement of previous assistance and is designed as a continuing and expanding program. A large portion of the aid extended under the Point Four program is extended through the facilities of the United Nations. Recipients of aid from the United States are sometimes sensitive that it may imply United States intervention in their domestic affairs; at least the opposition press and Communist propaganda may make such charges. When the aid is extended through the United Nations these charges become obviously false.

European Recovery Program.—The United States has backed its foreign economic policy with dollars, and during recent years has provided foreign countries with large sums of money for relief, reconstruction, development, defense and other purposes. Special financial assistance has been extended to Greece, Turkey, India, and other countries. A considerable portion of the financial aid given to foreign countries during recent years has been in connection with the European Recovery Program (ERP), the Marshall Plan as it is often known, after Secretary of State George C. Marshall who proposed the plan. Military assistance has also represented large sums.

The ERP assistance, administered by the Economic Cooperation Administration (ECA) created by Congress in 1948, was made available to Europe at a critical period. When unrest and subversive activities which took advantage of the reduced living standards threatened the democratic and free institutions of Europe, United States money made possible the importation of essential goods and services and the reconstruction of Europe's productive capacity devastated by the war. Goods of all types needed to reconstruct Europe's cities, ports, transportation, industries, and economies generally were supplied by the United States.

The countries of Europe lacked dollars with which to buy needed American goods and were unable to export sufficiently

to earn the necessary supply of dollars. The countries had large deficits in their balance of payments which the United States through the ERP program helped to meet.

The ERP money was extended largely on a grant basis since the United States recognized that to burden these countries with heavy debts to the United States beyond their capacity to repay would have been unwise and would have interfered with the purposes for which the aid was given.[3] Local currency received by the recipient governments, as a result of the sale of goods supplied by grants from the United States, was placed in a special account. These so-called local currency counterpart funds were expendable by the recipient government only with the concurrence of the United States. The purposes for which these funds could be spent were those such as debt retirement, construction of public facilities, or other purposes of public benefit.

The program brought renewed hope and confidence to European peoples and succeeded in aiding the restoration of Europe's economic health. The program was designed to help Europe to help itself and was generally regarded as highly successful. By relieving the unbalanced condition in European trade and production it facilitated the relaxation of restrictive controls, although the European countries were unwilling to liberalize trade to the extent that some persons considered feasible.

From the middle of 1945 until the first of 1951 the amount of funds provided foreign countries by the United States through loans or grants totaled approximately $30.1 billion (excluding amounts not utilized). Of this amount $10.6 billion was in the form of loans and $19.5 billion in the form of grants. About $2.1 billion of the loans had been repaid as of the first of 1951. Tables 12 and 13 show the details of United States foreign financial assistance and the large sum represented by the European Recovery Program.

[3] To the extent that aid was given in the form of loans (such loans as there were being largely during the first year of the program), the Export-Import Bank served as the agency to handle the transaction. These ECA loans, however, were separate from other loans of the Bank and were not made out of the Bank's own resources.

TABLE 12

Foreign Aid Programs of the U. S. Government by Type

Grants and Credits Utilized in the Postwar Period, by Calendar Years, and Unutilized as of December 31, 1950

(In millions of dollars)

Program	Utilized in the Postwar Period (Calendar Years)							Unutilized Dec. 31, 1950
	Total Utilized	1950	1949	1948	1947	1946	1945 last half	
Total, All Programs	30,153	4,494	6,028	5,588	6,202	5,701	2,140	12,136
Total, Grants	19,512	4,050	5,337	4,168	2,076	2,614	1,267	10,506
Economic Cooperation	8,092	2,803	3,799	1,491	–	–	–	3,331
European Recovery Program	7,838	2,730	3,714	1,395	–	–	–	3,090
Far Eastern (General area of China) aid	175	17	62	96	–	–	–	90
Korean aid	78	56	23	–	–	–	–	152
Lend-Lease & Civilian Supplies	5,422	351	985	1,370	968	1,078	671	362
Lend-Lease	1,968	–	–	2	18	828	1,121	–
Civilian supplies	4,710	353	985	1,377	997	654	343	362
(Credit offsets to grants)	Cr. 1,256	Cr. 2	(Cr.[1])	Cr. 9	Cr. 47	Cr. 404	Cr. 794	–
UNRRA, Post-UNRRA, & Interim Aid	3,443	(Cr.[1])	1	625	868	1,470	479	–
UNRRA	2,589	–	(Cr.[1])	–	640	1,470	479	–
Post-UNRRA	299	–	2	81	216	–	–	–
Interim aid	556	(Cr.[1])	Cr. 1	545	12	–	–	–
Other Grants	2,555	896	553	683	240	66	117	6,813
Greek-Turkish aid	656	61	172	349	74	–	–	14
Philippine rehabilitation	619	166	203	130	86	33	–	16

Mutual-defense assistance	516	516	–	–	–	–	–	6,675
Chinese stabilization and military aid	240	5	44	72	–	15	105	12
Technical assistance and inter-American aid	137	27	30	16	46	11	7	30
Int'l. Refuge assistance	231	51	71	89	19	2	–	8
Int'l. Children's Fund	75	15	18	27	15	–	–	(1)
Palestine relief	35	20	15	–	–	–	–	8
Donations of agricultural surplus	36	36	–	–	–	–	–	11
American Red Cross	10	–	–	–	–	5	5	–
Yugoslavia	–	–	–	–	–	–	–	38
Total, Credits	10,641	444	691	1,419	4,126	3,086	873	1,630
Export-Import Bank	2,733	200	185	429	824	1,037	58	1,280
Economic Cooperation	1,061	157	428	476	–	–	–	142
War Account settlements	1,387	(1)	(1)	12	48	763	562	–
Other lend-lease and surplus property	1,278	3	32	193	248	549	253	3
Other loans & commodity credits	4,183	84	47	309	3,006	737	(1)	206
Anglo-American financial agreement	3,750	–	–	300	2,850	600	–	–
R.F.C. British loan	–	–	–	–	–	–	–	35
United Nations loan	44	22	20	3	–	–	–	21
Commodity credits	283	28	27	7	86	137	–	150
Miscellaneous loans	105	35	(1)	(1)	70	(1)	(1)	–

[1] Less than $500,000.

Note: A table comparable to the above, but showing data ***on a fiscal year basis*** through June 30, 1950, may be found on Page 52 of the *NAC Report* for the 6 months ending September 30, 1950.

(Source: Clearing Office for Foreign Transactions, Department of Commerce.)

TABLE 13

Postwar U. S. Government Foreign Grants and Credits by Countries July 1, 1945, to December 31, 1950

(In millions of dollars)

Area and Country	Net Postwar Aid	Utilized			Returned and Repaid		
		Total	Grants	Credits	Total	Grants	Credit Repayments
Total, All Areas	28,094	30,153	19,512	10,641	2,058	603	1,456
Total, Europe	22,086	23,179	14,098	9,081	1,094	460	634
Total, ERP Participants	20,547	21,556	12,984	8,573	1,009	433	576
Austria	754	758	733	25	3	–	3
Belgium & Luxembourg	683	722	509	213	39	(1)	39
Denmark	218	219	167	52	1	1	(1)
France	3,998	4,093	1,972	2,121	95	5	90
Germany	3,134	3,177	3,069	108	43	1	42
Greece	1,225	1,238	1,127	111	13	(1)	12
Iceland	13	13	10	3	–	–	–
Ireland	122	122	3	119	–	–	–
Italy	2,072	2,135	1,723	412	63	6	57
Netherlands	960	1,022	585	437	62	6	56
Norway	232	247	132	115	16	(1)	15
Portugal	18	18	8	10	(1)	(1)	–
Sweden	86	88	64	24	2	–	2
Switzerland	2	2	2	–	–	–	–
Trieste	38	38	38	–	–	–	–
Turkey	251	268	174	94	17	4	13
United Kingdom	6,053	6,708	1,980	4,728	655	409	246
Unallocated ERP	687	687	687	–	–	–	–
Total, Other Europe	1,539	1,623	1,114	509	84	26	58
Albania	20	20	20	–	–	–	–
Czechoslovakia	189	213	183	30	24	(1)	24
Finland	97	128	2	126	31	–	31
Hungary	16	18	2	16	2	–	2
Poland	442	443	365	78	1	–	1
U.S.S.R.	439	465	243	223	26	26	–
Yugoslavia	335	335	298	37	(1)	–	(1)
Total, Latin America	352	559	133	426	207	(1)	207
Argentina	(1)	(1)	(1)	(1)	(1)	–	(1)
Bolivia	23	24	3	22	1	–	1
Brazil	60	104	6	98	44	–	44
Chile	78	109	5	104	30	(1)	30
Colombia	18	33	2	32	15	(1)	15
Cuba	Cr. 2	11	(1)	10	13	(1)	13
Ecuador	11	13	3	10	3	(1)	3
Haiti	Cr. 1	3	3	1	5	(1)	5
Mexico	156	208	87	120	51	(1)	51
Peru	8	10	4	6	2	(1)	2
Uruguay	9	11	1	10	2	(1)	2
Venezuela	2	5	1	3	3	(1)	3
Other Latin America	7	16	10	6	9	(1)	9
Unallocated L. A.	Cr. 17	11	7	4	29	–	29

TABLE 13—*Continued*

Area and Country	Net Postwar Aid	Utilized			Returned and Repaid		
		Total	Grants	Credits	Total	Grants	Credit Repayments
Total, Asia	4,874	5,363	4,471	892	489	30	459
Bahrein Islands	Cr. 16	–	–	–	16	–	16
Burma	4	5	(1)	5	1	–	1
China	1,683	1,796	1,567	229	114	–	114
India	13	46	1	45	33	29	5
Indonesia	149	151	88	63	2	2	(1)
Iran	20	30	Cr. 8	37	10	–	10
Israel	48	48	–	48	–	–	–
Japan	1,720	2,007	1,706	301	287	–	287
Korea (southern)	355	359	334	25	4	–	4
Philippines	755	769	655	114	14	–	14
Ryukyu Islands	60	60	60	–	–	–	–
Saudi Arabia	12	17	2	16	5	–	5
Thailand	5	6	(1)	6	1	–	1
Other Asia	1	3	(1)	3	2	–	2
Unallocated Asia	65	65	65	–	–	–	–
Canada	1	142	–	142	141	–	141
Total, Africa	Cr. 62	43	1	42	105	92	13
Egypt	8	18	(1)	18	11	–	11
Liberia	17	17	(1)	17	–	–	–
Union of South Africa	Cr. 92	1	–	1	94	92	1
Other Africa	5	6	(1)	6	1	–	1
Total, Oceania	9	31	19	13	22	20	2
Australia	Cr. 2	20	12	8	22	20	2
New Zealand	6	7	2	4	(1)	–	(1)
Other Oceania	4	4	4	–	–	–	–
Unallocated, Int'l Org.	663	663	619	44	–	–	–
Unallocated, All Areas	171	171	171	–	–	–	–

[1] Less than $500,000.
(Source: Clearing Office for Foreign Transactions, Department of Commerce.)

In connection with the ERP the sixteen European countries participating in the program established the Organization of European Economic Cooperation (OEEC).[4] This organization was a focal point in the administration of Marshall Plan aid and has performed other important functions. It has endeavored, among other things, to promote policies to expand trade and facilitate European recovery generally. The United States encouraged the OEEC countries to reduce barriers to intra-European trade and to pursue liberal commercial policies. The OEEC with United States support and financial aid organized in 1950 the European Payments Union (EPU) as discussed in Chapter 24. Members of the EPU have been required to reduce import quotas with respect to trade with each other.

Export-Import Bank of Washington.—The principal lending agency of the United States Government is the Export-Import Bank of Washington. This bank was created in 1934 to help finance trade with the Soviet Union, which had been recently recognized by the United States. The second Export-Import Bank was created in the same year to extend credits to Cuba and other countries. At that time, United States foreign trade was far from prosperous, and these two banks were

[4] Members of the OEEC and other European organizations are as follows:

Organization for European Economic Cooperation	*North Atlantic Treaty Organization*	*Council of Europe*
Austria		
Belgium	Belgium	Belgium
Denmark	Denmark	Denmark
France	France	France
Federal Republic of Germany		Federal Republic of Germany
Greece		Greece
Iceland	Iceland	
Ireland		Ireland
Italy	Italy	Italy
Luxembourg	Luxembourg	Luxembourg
Netherlands	Netherlands	Netherlands
Norway	Norway	Norway
Portugal	Portugal	
Sweden		Sweden
Switzerland		
Trieste		
Turkey		Turkey
United Kingdom	United Kingdom	United Kingdom
Canada	Canada	
United States	United States	

intended to help revive trade. Negotiations regarding settlement of the debts of the Soviet Union broke down in 1935, and no loans to it were made. The two banks were then combined into one institution. The Bank's resources were small and during its first five years it disbursed less than $62 million, of which about $35 million was repaid within that time. Its operations were confined largely to the financing of United States exports, particularly agricultural products. It endeavored then as now to avoid competing with private banks and thus sought to confine its operations to business not desired by private banks.

As the international situation became increasingly threatening prior to the outbreak of war in 1939, the original purpose of the Bank, financing lagging foreign trade, was little by little expanded to include financial assistance to foreign governments and the implementation of United States foreign policy. Loans were made to China when China was in need of dollars in connection with her war with Japan, and to Latin-American countries which were being infiltrated by Germany. The good-neighbor policy needed tangible support, and these countries required help in combating the growing danger from Nazi Germany. The Bank's resources were expanded in 1940 and its functions and purposes defined in a way to leave no doubt that it was to operate as an instrument of foreign policy, particularly in the Western Hemisphere.

In 1945 the Bank's lending authority was increased to $3.5 billion so that it could play a more important role in postwar reconstruction and also in economic development. It accordingly made large loans to European and other countries. A further increase of $1 billion in the Bank's lending authority was requested of Congress in 1951. As of the first of 1951, the Bank had disbursed $3.2 billion in loans, of which $1,010 million had been repaid. Total loans then outstanding amounted to $2,219 million. The Bank's losses have been small, and net earnings, after allowing for the cost of money supplied by the United States Treasury, have been substantial. The Bank's borrowers include most of the governments of the world. It also

lends to private borrowers but ordinarily only over a government guarantee.[5]

Financial Aid to World War I Allies.—During the first World War the United States Government extended large loans to its allies to purchase goods in the United States which they needed. The money was spent for munitions, food, and a variety of articles which the United States was able to supply. The goods were purchased before the United States entered the war, during United States participation, and after the Armistice. The total of these loans amounted to $10.338 billion.[6] After the war the nations made arrangements for the repayment of these loans over a long period of years. In these funding agreements the United States reduced the interest payments materially, the reduction varying according to estimated ability to pay. The reductions had the effect of cutting the total debts roughly in half. On the funded basis Great Britain was supposed to pay some 70 per cent of her debt, France about 40 per cent, and Italy about 20 per cent.

Considerable discussion took place during the 1920's over the question of whether the United States should collect these debts, or should cancel them on the ground that they represented the United States contribution to the war. The European countries pressed the United States to cancel them, arguing that the United States contribution to the war in lives was much smaller than that of Europe, that the debts were excessively burdensome and too large to be paid without disrupting international trade. Certain banking interests in the United States sided with the European countries. These countries had borrowed extensively in the private American market, and the repayment of the private debts would be facilitated if the United States Government canceled the debts owing it.

The European governments sought to link the war debts to German reparations, and said that the governments could not

[5] In the United Kingdom the Colonial Development Corporation, a public corporation, is somewhat similar to the Export-Import Bank, but operates only in British Colonies.

[6] Accumulations of interest prior to funding of the debts increased the funded amount to $11.231 billion.

reduce their reparation demands upon Germany if they were to pay their war debts to America. German reparation payments had become a burden on German recovery, a source of political irritation, and a hindrance to an improvement in European conditions. The United States had alone opposed the principle of indemnities and had refused to share in them, but was now made to appear as the reason for their existence. The United States took the position that the debt payments under the funding agreements were not excessively burdensome, and that it was a distortion to link them to reparations since a particular source of income cannot validly be said to be required to meet a particular expenditure. The United States refused to participate in a conference to consider debts and reparations. Europeans considered the United States mercenary and unreasonable. The ill-will and confused discussions on both sides prejudiced the aspect of the case which appealed to a large number of Americans, namely, that the war was a common war and that the United States should not attempt to collect money for the contribution which it had made in goods. The growth of isolationism in the United States and disappointment over the trend of affairs in Europe worked against cancellation.

As the depression of the 1930's became increasingly severe, the idea was put forward that the war debt and reparation situation was a main cause of the trouble, and that if these problems were solved prosperity would return. The debt and reparation problem no doubt aggravated the difficulty but was probably not more than a minor factor in the depression. President Hoover in June, 1931, offered to postpone payments on the war debts for one year, if the European governments would similarly postpone reparation payments. This offer was immediately accepted, and marked the end of both war debt and reparation payments, with the exception of debt payments by Finland, which are still being made, and a few small token payments by other debtors, soon discontinued. The payments by Finland are now used for cultural purposes, Finland participating in the benefits.

Because of the failure of European countries to resume and maintain payments at the end of the moratorium, the Johnson

Act was passed by Congress in 1934, prohibiting governments wholly or partially in default to the United States Government from borrowing in this market. Private corporations in such countries could still borrow here. In 1945 this Act was made largely ineffective as noted elsewhere (see Chapter 28).

The total sums received by the United States as war-debt interest and principal payments amounted, as of 1951, to $2.753 billion. If accumulated interest is included the total amount of the outstanding debts due the United States amounted in 1951 to approximately $16.5 billion dollars, which compares with the principal of the original advances of $10.3 billion.

Lend-Lease Aid.—The Lend-Lease Act of March, 1941, enacted before the United States entered the second World War, was designed to avoid the troubles arising out of advances made by the United States Government during the first World War. As dollar resources of Great Britain became depleted and as sentiment in the United States turned more and more against the Axis, it was clear that action of some kind was necessary in order to aid Great Britain. The Act accordingly authorized the President, "to sell, transfer title to, exchange, lease, lend, or otherwise dispose of, to any such government..." (i.e., "any country whose defense the President deems vital to the defense of the United States")[7] any defense article, which was defined in broad terms.

The President was given wide authority by the Act "in the final determination of the benefits to be provided to the United States." In his Fifth Report to Congress on Lend-Lease Operations the President said:

...The transfers made under the Lend-Lease Act are not commercial loans to other nations. They are contributions of material to a common pool with which a common war is being waged. In return, other United Nations are contributing their utmost to the common fight—in men, materials and machines—and are furnishing us with the weapons and supplies which we, rather than they, can most effectively use....

...The real costs of the war cannot be measured, nor compared, nor paid for in money. They must and are being met in blood and toil. But

[7] Lend-Lease Act, Section 3, Public Law No. 11, 77th Congress, 1st Session.

the financial costs of the war can and should be met in a way which will serve the needs of lasting peace and mutual economic well-being.

All the United Nations are seeking maximum conversion to war production, in the light of their special resources. If each country devotes roughly the same fraction of its national production to the war, then the financial burden of war is distributed equally among the United Nations in accordance with their ability to pay. And although the nations richest in resources are able to make larger contributions, the claim of war against each is relatively the same. Such a distribution of the financial costs of war means that no nation will grow rich from the war effort of its allies. The money costs of the war will fall according to the rule of equality in sacrifice, as in effort....

The form which settlement of lend-lease aid was to take after the war was expressed only in general terms. Unused materials were to be returned. The agreement with the United Kingdom, which served as a model and embodied the same terms as agreements with Soviet Russia, China, and the long list of other countries, authorized postponement of settlement until after the war and repayment in a form that would not burden commerce. Aid received by the United States from other countries, i.e., reverse lend-lease, was also to be considered.

Article VII in the Master Agreement with China, similar to that in the other agreements, reads:

In the final determination of the benefits to be provided to the United States of America by the Government of the Republic of China in return for aid furnished under the Act of Congress of March 11, 1941, the terms and conditions thereof shall be such as not to burden commerce between the two countries, but to promote mutually advantageous economic relations between them and the betterment of world-wide economic relations. To that end, they shall include provision for agreed action by the United States of America and the Republic of China, open to participation by all other countries of like mind, directed to the expansion, by appropriate international and domestic measures, of production, employment, and the exchange and consumption of goods, which are the material foundations of the liberty and welfare of all peoples; to the elimination of all forms of discriminatory treatment in international commerce; to the reduction of tariffs and other trade barriers; and, in general, to the attainment of economic objectives identical with those set forth in the Joint Declaration made on August 14, 1941, by the President of the United States of America and the Prime Minister of the United Kingdom....

TABLE 14

WARTIME U. S. GOVERNMENT FOREIGN GRANTS AND CREDITS

JULY 1, 1940, TO JUNE 30, 1945 *

(In millions of dollars)

Area and Country	Net Wartime Aid	Utilized			Returned and Repaid		
		Total	Grants	Credits	Total	Reverse Lend-Lease, etc.	Credit Repayments
TOTAL, ALL AREAS	40,977	49,224	48,128	1,096	8,246	7,869	378
Total, Europe	37,420	43,705	43,219	486	6,286	6,142	144
Total, ERP Participants	26,493	32,757	32,286	471	6,264	6,135	129
Austria	1	1	1	–	–	–	–
Belgium & Luxembourg	Cr. 136	69	69	–	205	205	–
France	1,754	2,621	2,621	–	867	867	–
Greece	79	79	79	–	–	–	–
Iceland	(Cr. †)	†	†	†	1	–	1
Ireland	†	†	†	–	–	–	–
Italy	306	310	310	–	4	–	4
Netherlands	114	151	115	36	37	37	–
Norway	37	37	37	–	†	–	†
Portugal	Cr. 1	†	–	†	1	–	1
Sweden	Cr. 3	1	1	–	4	–	4
Turkey	90	90	90	–	–	–	–
United Kingdom	23,907	29,052	28,618	434	5,145	5,027	118
Unallocated ERP	345	345	345	–	–	–	–
Total, Other Europe	10,926	10,948	10,933	15	22	7	15
Czechoslovakia	8	8	8	–	–	–	–
Finland	14	17	1	15	2	–	2
Poland	21	22	22	–	†	–	†
Spain	Cr. 11	2	2	†	13	–	13
U.S.S.R.	10,769	10,776	10,776	–	7	7	–
Yugoslavia	33	33	33	–	–	–	–
Unallocated Other Europe	90	90	90	–	–	–	–
Total, Latin America	596	742	423	319	146	–	146
Bolivia	4	6	2	5	2	–	2
Brazil	51	79	12	67	28	–	28
Chile	16	24	3	21	8	–	8
Colombia	12	24	2	22	12	–	12
Costa Rica	8	9	1	7	†	–	†
Cuba	3	18	†	18	15	–	15
Ecuador	9	9	4	6	1	–	1
Haiti	7	9	1	8	2	–	2
Mexico	18	22	7	15	4	–	4
Nicaragua	4	5	1	4	1	–	1
Paraguay	7	7	2	5	1	–	1
Uruguay	8	8	1	7	†	–	†
Venezuela	5	8	2	5	2	–	2
Other Latin America	15	18	10	8	4	–	4
Unallocated L. A.	429	495	374	121	66	–	66

TABLE 14—*Continued*

(In millions of dollars)

Area and Country	Net Wartime Aid	Utilized			Returned and Repaid		
		Total	Grants	Credits	Total	Reverse Lend-Lease, etc.	Credit Repayments
Total, Asia	1,510	2,157	1,915	242	647	586	61
Bahrein Islands	16	17	–	17	1	–	1
China	1,247	1,311	1,231	80	64	4	60
India	160	742	610	132	582	582	–
Iran	8	8	8	–	–	–	–
Philippines	53	53	53	–	–	–	–
Saudi Arabia	18	18	5	13	–	–	–
Other Asia	8	8	8	–	–	–	–
Canada	7	33	–	33	26	–	26
Total, Africa	119	120	112	8	1	1	†
Algeria	16	16	16	–	–	–	–
Ethiopia	5	6	1	4	†	–	†
U. South Africa	92	92	92	–	1	1	–
Other Africa	6	6	2	3	–	–	–
Total, Oceania	16	1,156	1,148	8	1,140	1,140	–
Australia	17	905	897	8	888	888	–
New Zealand	Cr. 2	249	249	–	252	252	–
Other Oceania	2	2	2	–	–	–	–
Unallocated, Int'l. Org.	53	53	53	–	–	–	–
Unallocated, All Areas	1,257	1,257	1,257	–	–	–	–

* For qualifications affecting this table and for definitions of terms, see National Advisory Council on International Monetary and Financial Problems. Semiannual Report for the Period April 1, 1950-September 30, 1950, which is the source of this table.

† Less than 500,000.

Total lend-lease transfers by the United States during and after the second World War amounted to $49.224 billion, including aid extended on cash repayment terms and amounting to about $1.1 billion. A little less than $2 billion of this total amount of lend-lease aid was given after the war. The aid received by the United States from other countries, reverse lend-lease, etc., totaled $7.869 billion, so that the net amount of lend-lease aid extended as grants amounted to a little over $40 billion. Table 14 shows the details of lend-lease aid.

Mutual Security Program.—As a result of the North Atlantic Treaty (ratified by the United States in 1949), and plans

for common defense, which were expanded following the Communist invasion of Korea, the United States has been extending a large amount of assistance under the Mutual Defense Assistance Program to European, Latin-American, and other countries cooperating in resistance to aggression. The aid is largely in the form of direct grants, although in some instances naval vessels and other items have been sold to foreign governments.

The appropriateness of aid on a grant basis has now become well established. President Truman in his budget message for 1952 said:

> Our international programs recognize that this nation's own security is directly related to the security and defensive strength of our allies and that equipment and materials supplied to help arm their forces or to support their military production are, in fact, additions to our own defensive strength.... Each free nation must make the largest contribution it can to the mutual defense. This nation has greater industrial strength than the rest of the free world combined, and must therefore provide assistance on a large scale to other nations working with us in the joint defense drive.

In addition to military assistance, economic aid to foreign countries is continuing and in some cases being expanded. At the present time such aid is focused especially on its contribution to the defense program, such as facilitating the production of strategic materials, strengthening the economies of weak countries and raising living standards, particularly in countries where Communist stimulated disturbances threaten world security.

In a special message to Congress in May, 1951, President Truman requested that $8,500 million be appropriated to finance a proposed Mutual Security Program. This sum was to be utilized entirely on a grant basis. Of this amount $6,250 million was for military assistance and $2,250 million for economic aid. The plan consolidated into one program the various types of previous foreign aid including that of the Marshall Plan, the Mutual Defense Assistance Program, and aid to underdeveloped countries under the Point Four Program. Plans were

also underway whereby the life of the Economic Cooperation Administration, which was originally created to administer Marshall Plan aid, would be continued. The United States is thus pursuing a course of major aid on a grant basis to foreign countries. The benefits from the Marshall Plan and other programs have in the eyes of most people justified such a course.

Coordination of Policy.—In view of the varied nature of the foreign economic problems confronting the United States, and the many United States interests affected, various government agencies participate with the State Department in the formulation and carrying out of policies. Most of the forty-five (at a recent count) agencies of the federal government are directly or indirectly concerned with some phase of this country's foreign relations. Their participation in foreign policy takes place largely through about thirty-three joint committees and about 142 subcommittees which study and advise on foreign affairs.

In the financial field the National Advisory Council on International Monetary and Financial Problems (NAC), created by Congress in 1945, has the responsibility of coordinating the policies and operations of the United States representatives on the International Monetary Fund and the World Bank, the Export-Import Bank and all other government agencies "to the extent that they make or participate in the making of foreign loans or engage in foreign financial, exchange or monetary transactions." The National Advisory Council consists of the Secretary of the Treasury (chairman), Secretary of State, Secretary of Commerce, Chairman of the Board of Governors of the Federal Reserve System, Chairman of the Export-Import Bank, and the Administrator for Economic Cooperation. Its functions have expanded beyond those narrowly defined by Congress, and the Council considers matters in the general field of international financial policy.

Chapter 35

UNITED STATES ECONOMIC RELATIONS WITH LATIN AMERICA

Inter-American Economic Cooperation.—When the countries of Central and South America broke away from Spain and declared their independence during the early part of the last century, the United States was among the first countries to recognize the new republics. Furthermore, President Monroe in December, 1823, declared that the European countries were not to impose their system or attempt further colonization in this hemisphere—a statement which came to be the basis for United States policy in this part of the world.

Until the last few decades, however, the United States did not exhibit much interest in efforts toward inter-American cooperation and solidarity. At the Congress of Panama in 1826, called by Simon Bolivar when President of Peru, the United States was not represented since the Senate failed to approve participation until too late. This first move on the part of the American republics toward Pan-American cooperation was not followed by other conferences until 1847-1848, when several of the countries sent representatives to Lima. During the interval Mexico had on several occasions endeavored to assemble congresses, but without success. A few other conferences were held at scattered intervals, not very well attended, and while nothing concrete came from them, they, nevertheless, indicated that the American republics felt a common bond and had an interest in cooperation.

Finally, in 1889, at the request of the United States, all of the American republics, except the Dominican Republic, sent representatives to a conference at Washington. Out of this conference came the Pan-American Union, established in 1890

originally as the Commercial Bureau of the American Republics, and interested at that time largely in commercial affairs. Its name was changed in 1910 to the Pan-American Union. It established permanent headquarters in Washington. No plans were made for further conferences, but at the suggestion of President McKinley a second conference met in Mexico City late in 1901. At this meeting arrangements were made for a third conference which was held in Rio de Janeiro in 1906. The fourth conference was held in Buenos Aires in 1910, the fifth in Santiago in 1923, the sixth in Havana in 1928, the seventh in Montevideo in 1933, the eighth in Lima in 1938, and the ninth International Conference of American States, as they were known, in Bogota in 1948. The name is now the Inter-American Conference. The tenth conference is scheduled for Caracas in 1953.

In addition to these general conferences, which meet ordinarily every five years, there have been a number of special conferences. In 1936, at the suggestion of President Roosevelt, there was held in Buenos Aires the Inter-American Conference for the Maintenance of Peace. The Ministers of Foreign Affairs met at Panama in 1939, at Havana in 1940, at Rio de Janeiro in 1942, and in Washington in 1951, to consider problems relating to common defense in the light of the general international situation. In 1945 there was held in Mexico City the Inter-American Conference on Problems of War and Peace, and in 1947 in Rio de Janeiro the Inter-American Conference for the Maintenance of Continental Peace and Security. A number of technical conferences have also been held from time to time dealing with such matters as agriculture and health.

Several significant results have come out of these conferences. In addition to the results, noted below, of the regular five-year conferences, the Havana conference in 1940 adopted a resolution to the effect that an attack on one American state by a non-American state would be considered an attack upon all of them. This principle was enunciated again at the Mexico City conference in 1945 and embodied there in the Act of Chapultepec and in the Declaration of Mexico. This Act contemplated the possible use of armed force by the American republics to meet

aggression, and recommended consideration be given to conclusion of a treaty. The Inter-American Treaty of Reciprocal Assistance was accordingly signed at Rio de Janeiro in 1947 and put the matter of collective action for defense into treaty form. The treaty obliges the parties to assist in meeting an attack from an aggressor on any American state, and to consult to decide the collective measures required of all. Decisions taken by a two-thirds vote are binding on all, except that no state is required to use armed force without its consent. The treaty establishes a clear obligation on the parties to take action in meeting an armed attack and provides for consultation on any situation endangering the peace. The treaty of Rio has now been ratified by 20 American republics, including the United States (Guatemala is willing to ratify with a reservation), and is now in force. It represents an important milestone in Inter-American defense and solidarity. The collective security arrangements of the North Atlantic Treaty are patterned after those of the Rio treaty.

In order to settle disputes before they result in armed conflict the Bogota conference drafted the Treaty of Pacific Settlement or Pact of Bogota, as it is known. This treaty, not yet in effect, provides for machinery to settle bilaterally disputes that may arise among the American states. If these procedures are unsuccessful the Rio treaty provides for such joint action by all of the states as is necessary to maintain or restore peace, including possible armed force.

The Mexico City conference in 1945 made plans for the reorganization of the Inter-American system, which was worked out in detail at the Bogota conference in 1948. The Mexico City conference also adopted what is known as the Economic Charter of the Americas, which is a declaration covering a wide range of economic subjects such as standards of living, elimination of trade barriers, commercial policy, private investment, etc.

Organization of American States.—The Inter-American system, which was represented by the Pan-American Union, by a variety of conferences held from time to time, by joint

declarations and agreements, and by a number of special commissions, had grown like Topsy and was in need of overhauling, consolidation and simplification. The United Nations Charter, drafted in San Francisco in 1945, makes provision in Chapter VIII for regional arrangements. In Bogota in 1948 a constitution or charter for the Organization of American States (OAS) was drawn up in treaty form, in accordance with plans undertaken in Mexico City in 1945.[1]

According to the Bogota charter, as the treaty-document is known, the "supreme organ of the Organization" is the Inter-American Conference which meets generally every five years in the different countries. In this conference each state has one vote. The permanent executive body is the Council of the Organization (OAS) consisting of one representative from each state, which is established in Washington and which ordinarily meets once or twice a month. Under the Council is the Pan-American Union which is the general secretariat and focal point for the entire Organization. It has been reorganized internally and strengthened. It maintains a staff of workers and is an active operating agency.

Also reporting to the Council, and to the Conference, are the Inter-American Economic and Social Council (IA-ECOSOC), the Inter-American Council of Jurists, and the Inter-American Cultural Council. The Economic and Social Council was established as a result of action taken at Mexico City in 1945. It was resolved there that, pending the contemplated general reorganization to be undertaken at Bogota, the Economic and Social Council be organized at once, so that it could deal with urgent matters requiring attention, particularly measures to facilitate economic development. Accordingly the existing Inter-American Financial and Economic Advisory Committee was converted into the Economic and Social Council without waiting for the

[1] As of July, 1951, thirteen states including the United States had deposited ratifications and other ratifications were expected soon. Fourteen were needed to bring the charter into force. The United States had delayed its ratification since the United States awaited views of other states on its reservation that the treaty neither enlarged the powers of the federal government nor limited those of the states of the United States.

conference in Bogota in 1948. It is an agency which undertakes studies, provides consultation among the states, and makes recommendations on economic and social matters.

There are also a number of specialized technical organizations in such fields as health, transportation, commerce, geography, and history. Examples are the Pan-American Sanitary Bureau, and the Inter-American Institute of Agricultural Sciences. The relation of these technical agencies to the OAS is defined in agreements which have been completed in some cases and in others are in process of being worked out.

At the urging of several of the American republics the United Nations established the Economic Commission for Latin America (ECLA) in 1948, similar to other regional commissions which it had established. ECLA is not a part of the Organization of American States, but reports to the United Nations Economic and Social Council. It has held meetings in Santiago, Havana, Montevideo, and Mexico City. Its main headquarters are in Santiago where it maintains a staff of workers who have made valuable studies. Its functions and those of IA-ECOSOC overlap somewhat, but nevertheless ECLA is making a worthwhile contribution toward an understanding and solution of Latin American economic problems.

The Bogota conference in 1948, in addition to arranging for a reorganization of the Inter-American system, drafted what is known as the Economic Agreement of Bogota. This agreement covers a wide range of subjects such as private investments, economic development, and transportation. Several countries, however, attached a number of reservations to the Agreement, and it has never been ratified by the necessary two-thirds of the countries. The United States did not wish to accept it in the light of the reservations of some countries, particularly reservations to the effect that certain assurances to investors set forth in the Agreement were subordinate to local laws. Efforts subsequently to eliminate the various reservations or to find a generally acceptable restatement of them were unavailing.

The Meeting of Consultation of Ministers of Foreign Affairs held in Washington in 1951, in its first resolution, the Declaration of Washington, expressed the determination of the Ameri-

can republics unitedly to resist Communist aggression. This declaration reaffirmed the principles of the OAS and also urged support of the United Nations as the most effective means of maintaining peace and security. The Ministers recommended that the American republics orient their military preparations, on a basis of self-help and mutual aid, so as to give greater attention to the principle of collective defense. They also urged more effective representative democracy and observance of civil liberties and the rights of the individual.

The Foreign Ministers recommended that the American republics undertake measures to increase production of strategic materials and to control inflation. Many of the countries were fearful lest the need of supplies for economic development not receive adequate attention as a result of the large requirements of the defense program. The Foreign Ministers recommended that economic development be considered an "essential factor in the total concept of Hemisphere defense," that price controls apply equally to both exports and imports and that there be opportunities for consultation on allocation. The principle of relative equality of sacrifice, they said, should prevail.

The United States has played a leading role in the economic cooperation which has developed among the American republics. Inter-American economic cooperation was stimulated by the war, and also by the strong desire to hasten economic development. The Panama Conference in 1939 created the Inter-American Financial and Economic Advisory Committee, consisting of one representative from each country. This committee, aided financially by the United States, established the Inter-American Development Commission of five members, which in turn established national commissions in each of the countries. The Committee was replaced by the Economic and Social Council, a permanent body, as noted above. The Inter-American Financial and Economic Advisory Committee sponsored formation of an Inter-American Bank to help finance development. A convention for such a bank was drafted in 1940 and its approval by the United States Senate was requested by this country's executive. The Senate, however, never ratified the convention. After the formation in 1946 of the International

Bank for Reconstruction and Development, the United States no longer favored an Inter-American bank.

United States Relations with American Republics Prior to 1933.—Relations between the United States and the other American republics were, from about the beginning of this century until shortly before the second World War, not on a very satisfactory basis. Actions of the United States with respect to Latin America had to a considerable extent long been the subject of suspicion and disapproval in those countries. At the present time, however, this distrust and disapproval have almost entirely disappeared, and are replaced by mutual respect and confidence.

The countries to the south had felt that United States policy toward Latin America was determined by the interests of traders and investors—"dollar diplomacy"—and also that the United States had territorial aspirations southward. Instances cited of expansion at the expense of Hispanic America were the acquisition of Texas, California, and other states, and more recently the lease of the Panama Canal Zone. United States troops in Haiti, the Dominican Republic, and Nicaragua lent support to their fears. The Monroe Doctrine as it had been interpreted by Theodore Roosevelt, was characterized as a doctrine of intervention and exploitation. The American republics were distrustful of the "Colossus of the North," which in turn was often impatient and irritated at the disturbances and excesses in some of the countries.

The economic and financial relations between these countries and the United States have long been extensive despite the former friction. The United States has over six billion dollars invested in Latin America, and is the leading country in the foreign trade of most of these countries. This relationship, however, is the result of propinquity and natural economic forces. Latin America has sought contact with the United States and the United States has sought contact with Latin America, to their mutual advantage. The United States receives agricultural commodities and raw materials—coffee, sugar, wool, copper, lead, petroleum, nitrate, iron ore, henequen fiber, etc.—from these countries which in turn receive manu-

factured articles from the United States—machinery, iron and steel products, chemicals, textile manufactures, automobiles, etc.[2]

The United States policy toward these countries was for many years paternalistic, particularly in the Caribbean countries. The United States frequently intervened in their affairs, and occasionally landed troops to maintain order. Such interventions were in support of its general policy of preventing European powers from establishing themselves in this hemisphere. These protective interventions were, nevertheless, offensive to the peoples of these countries and contributed to the suspicion and ill-will. They were, it was sometimes charged, for the purpose of protecting United States investments and other economic interests in Latin America.

The Monroe Doctrine, which has been the basis of United States policy in this area since 1823, was expanded from a policy of opposing European aggression in the Western Hemisphere, to that of an exercise of international police power, as President Theodore Roosevelt described it in his annual message in 1904. To many Latin Americans, however, the policy of the United States seemed one of economic imperialism.

The Monroe Doctrine was originally adopted in the interest of this country against conspiring governments of Europe. It meant that the United States would not permit these nations to intrude themselves into the affairs of North or South America. The United States did not want European nations to get a foothold on this side of the Atlantic. Had it not been for the Monroe Doctrine and the firm stand taken by the United States, the Latin-American countries would doubtless today be colonies or protectorates of European nations, divided up as Africa and other parts of the world have been divided up.

The Monroe Doctrine is fundamentally a policy of opposing that which is inimical to the safety of this country and this hemisphere. As President Monroe said, referring to the European powers: "We should consider any attempt on their part to

[2] Approximately 35 per cent of total United States imports came from Latin America in 1950. Latin America received from the United States in 1950 approximately 50 per cent of total Latin-American imports, the amount being high because of the low level of exports from postwar Europe.

extend their system to any portion of this Hemisphere, as dangerous to our peace and safety." The Monroe Doctrine has never been a policy of seeking special privileges for American trade and investment. Secretary of State Hughes emphasized this in 1923, although his statement was not convincing to Latin Americans. He also declared that the actions of the United States in this hemisphere were not limited by the Monroe Doctrine, but might be determined upon grounds of international right and national security.

The United States has continuously sought to prevent European nations from landing troops in Latin America, and from obtaining even a temporary foothold there, since in the past such interventions in other parts of the world usually meant permanent possession. A result of this policy was that in the early part of this century, the United States considered the duty of maintaining reasonable order in these countries as devolving upon itself. It was felt that if the United States did not exercise some supervision over disturbed and weak areas, it would be impossible to prevent European nations from doing so. This reasoning was the basis for the international police policy which came to prevail for a time. If the United States, however, had sought to obtain Latin-American participation in the responsibility of maintaining the integrity of the hemisphere, as it has since done, much of the resentment would doubtless have disappeared.

During this period the United States was in general more concerned over the affairs of the nearby Caribbean countries than of the countries farther south. When the United States intervened in Haiti in 1915, Germany was desirous of obtaining a coaling station there and was ready with troops to straighten out the disordered situation. The United States intervened, according to Secretary of State Lansing, to terminate appalling conditions of anarchy and oppression, and to forestall the attempt of a foreign power to obtain a foothold so near our borders. A financial adviser was appointed to see that Haiti made a serious effort to pay her bills, and thereby to satisfy the demands of European creditors.

United States troops went into Nicaragua after conditions there under the tyrannical power of Zelaya had become increasingly difficult. The discontent caused by the abuses of his rule led to a state of almost continuous revolution; and all Central America had turned against him. The patience of European nations was tried, and if the United States had not intervened European nations would very probably have done so. In order to satisfy Europe, the finances of Nicaragua needed to be reorganized. In straightening out these finances, United States bankers probably went farther than necessary in the degree to which they became interested in the domestic affairs of the country. The program was unpopular in the eyes of Nicaraguans, although the country received much permanent benefit.

The United States Government in 1916 bought from Nicaragua canal rights for $3,000,000. The special interest of the United States in Nicaragua was in part to prevent this canal location from falling into the hands of Europeans. Prior to construction of the Panama Canal, the Nicaraguan canal route competed strongly with that finally selected at Panama. The United States may at some future time desire to construct a canal across Nicaragua, although the expansion of the Panama Canal deferred such possible action and no immediate plans are under consideration.

In speaking of the Dominican Republic, President Theodore Roosevelt said: "The patience of her foreign creditors had become exhausted, and at least one nation was on the point of intervention and was only prevented by the unofficial assurance of this Government that it would itself strive to help Santo Domingo in her hour of need." [3]

Inasmuch as the European nations had a policy of political intervention and even of landing troops when a weak country fell down in its financial obligations, the United States at various times exerted pressure upon Latin-American countries to straighten out their finances in order to forestall European action. United States interference was upon broader grounds

[3] John Parke Young, "All America Now Lends Money to the World," *New York Times*, Aug. 23, 1925.

than protecting trade and investment. United States policy centered around the principle of not allowing European nations what might have been considered by them a legitimate reason for intruding themselves into this hemisphere. When order was restored the United States withdrew, but there was no assurance as to when intervention might again take place.

In connection with the loans extended by United States bankers to Nicaragua and a few other countries, a collectorship of the customs was established in order to assure repayment. In the case of Nicaragua, a United States collector-general collected the customs revenues and, after paying for the expenses of collection, remitted to New York the amount necessary to service the loan. The balance was then turned over to Nicaragua. The collector-general was "nominated by the bankers, approved by the Secretary of State, and appointed by the Republic." [4]

Similar arrangements, although differing in detail, have existed in connection with loans to the Dominican Republic, Haiti, Liberia, and Bolivia. In the case of Salvador the loan contract provided that a fiscal representative of the bankers inspect the collection of customs, and that in case of default a collector-general should take charge. However, when Salvador defaulted in 1932, the United States Secretary of State refused to participate in the setting up of an American collectorship, as provided, the reason stated being that the United States had not recognized the existing government of Salvador.

The unappreciated paternalism of the United States toward Central America and the Caribbean countries was altered after 1925. United States financial supervision largely ceased regardless of local mismanagement. A collectorship of customs by a foreigner is offensive to the citizens of the sovereign country accepting such an arrangement, and breeds ill-will toward the country which made the loan and which appoints the collector. Procedures of this kind came to be out of harmony with the newer policy of the United States, especially that which began in 1933.

[4] John Parke Young, *Central American Currency and Finance* (Princeton, N. J.: Princeton University Press, 1925), p. 141.

Good Neighbor Policy; End of Intervention.—In his inaugural address in March, 1933, President Roosevelt announced a liberal and cooperative policy which became known as the Good Neighbor Policy. The President said: "In the field of world policy, I would dedicate this nation to the policy of the good neighbor—the neighbor who resolutely respects himself, and, because he does so, respects the rights of others—the neighbor who respects his obligations and respects the sanctity of his agreements in and with a world of neighbors." [5]

This announcement, later identified by the President with Latin America, was followed by several actions which made the new policy more concrete and convincing to the Latin Americans, notably the position taken by the United States at the Montevideo conference in 1933, together with understandings reached there, abrogation by the United States in 1934 of the Platt amendment which had long antagonized Cuba, withdrawal of marines from Haiti in 1934 and of financial control there, conclusion of a new treaty with Panama, and other measures.

The Montevideo conference in December, 1933, revealed the basic nature of the change in United States policy toward Latin America, in line with the President's previous statements. At this conference the United States accepted, although with certain reservation, the doctrine of nonintervention. Secretary of State Hull declared that "under the Roosevelt administration the United States Government is as much opposed as any other government to interference with the freedom, the sovereignty, or other internal affairs or processes of the government of other nations." [6]

As a result of the conference, sentiment immediately became more friendly toward the United States. The good feeling continued to grow, and by the time of the Inter-American Conference for the Maintenance of Peace, called by President Roosevelt and held in Buenos Aires in 1936, much of the traditional suspicion of Latin America toward the United States had disappeared. All of the 21 American republics were represented

[5] Howard J. Trueblood, "Progress of Pan-American Cooperation," *Foreign Policy Reports,* Feb. 15, 1940.
[6] *Ibid.*

at this conference which drew up peace machinery accepted by all.

The results of the latter conference included the so-called Consultative Pact, wherein the nations agreed to consult "in the event that the peace of the American Republics is menaced." The Consultative Pact was aimed particularly at European interference in Latin America, although not specifically mentioned in the pact. Such consultation was to be "for the purpose of finding and adopting methods of peaceful cooperation." [7] As a result of this assumption by the 21 republics of collective responsibility for the maintenance of the peace and integrity of the hemisphere, even though not a firm commitment for action, the United States accepted unreservedly the doctrine of non-intervention. Subsequent strengthening of joint responsibility at Havana in 1940, at Mexico City in 1945 by the Act of Chapultepec and the Declaration of Mexico, and finally by the treaty of Rio in 1947 and the Declaration of Washington in 1951, justified United States action.

The assumption of joint responsibility for the defense of the hemisphere did not involve any change in the Monroe Doctrine, which has long represented a national policy of the United States. Secretary of State Hughes in 1923 declared against a sharing of the Doctrine pointing out at that time that it was a distinctly United States policy. While United States approval of the Consultative Pact drawn up at the Buenos Aires Conference may have seemed to some persons to represent an implied sharing of the Doctrine, such an interpretation involves a misconception of the nature of the Doctrine which is a national policy of this country rather than an international agreement. The United States did not relinquish in any way its intention as embodied in the Monroe Doctrine of resisting foreign interference in the affairs of this hemisphere. However, under the policy of consultation and joint responsibility of all the American republics the United States would not expect to have to act unilaterally for the defense of the hemisphere. Its policy

[7] Charles G. Fenwick, "The Buenos Aires Conference: 1936," *Foreign Policy Reports,* July 1, 1937.

rather would be to promote action by the community of states to this end.

Intervention had long been a barrier to good relations between the United States and the American republics, and its abandonment was universally welcomed. The abandonment by the United States of the intervention policy was made possible to a large extent by the more enlightened policies of most of the European powers, and also by general recognition that the American hemisphere, as a result of United States policy, was forbidden territory for aggressive operations, and that no incursions there would be tolerated. Italy under Mussolini might attempt to conquer Ethiopia, and Japan to dominate Manchuria and other Far Eastern areas, but no country would have been so foolish as to have undertaken such adventures in the Western Hemisphere, particularly in the light of the increased strength of the United States. The United States was therefore able to relax its close vigilance over the affairs of Latin-American countries. Furthermore, the general development and advancement of these countries made joint responsibility more meaningful, as well as United States intervention less necessary. The countries had in large part attained their maturity.

At the conference held in Lima there was adopted the Declaration of Principles of Inter-American Solidarity and Cooperation. Although this declaration was in broad and general terms and did not contain anything very new, it was a clear statement of principles and ideas regarding the common interests and objectives of the American republics. It was regarded by some of the nations as a form of collective security. At Lima there were some suspicions that the United States was using the threatening situation in Europe to promote its own interests in Latin America. This criticism, however, soon died down, and at Panama, shortly after the outbreak of war, came the general Declaration of Neutrality, as well as the declaration that a safety zone extended 300 miles off shore—a so-called safety belt. None of the belligerents, however, recognized this safety belt.

When the United States entered the war in December, 1941, this country was promptly followed by the six Central American countries, Cuba, Haiti, the Dominican Republic, and later by Mexico, Brazil, and by all of the other countries of the hemisphere, although Argentina did not declare war until March 27, 1945. Chile was at war with Japan but not with Germany.

The United States and Latin-American Economic Development.[8]—The United States Government has, since the middle of the 1930's, extended a considerable amount of financial aid to the American republics for development and other purposes. From the inception of the Export-Import Bank in 1934 to December 31, 1950, the Bank authorized credits to Latin-American countries totalling $1,549 million. In addition, the United States Treasury has entered into exchange stabilization agreements with a number of countries and provided funds under these agreements to help maintain exchange stability. The United States Government has also made extensive purchases of materials in Latin America, and entered into contracts to stimulate production by agreeing to make purchases at fixed prices over extended periods of time. It has helped finance construction of the Inter-American highway and other projects. It has furnished technical assistance and cooperated in a variety of joint undertakings, especially in the field of health, education, and agriculture.

Prior to the inauguration of the Point Four Program in 1950 a large part of the technical assistance from the United States was rendered through the Institute of Inter-American Affairs,[9] which is now part of the Point Four Program. The Institute is a United States Government corporation, established by Congress in 1942, and joins with Latin-American governments in planning and carrying through specific projects. When the Institute and another government have agreed on a program, an office or bureau, a *servicio* as it is known, is established within the appropriate Ministry, usually the Ministry of Agriculture, of Health, or of Education. The Institute sends a field

[8] See also Chapter 30 on foreign economic development.

[9] See pages 550-51.

party of technicians to the country—public health doctors, sanitary engineers, etc.—one of whom is Director of the servicio. The staff of the servicio consists of these technicians together with a larger number of local technicians. Operations are carried on by agreement between the Director of the servicio and the appropriate Minister. Both governments provide funds for the program which are merged. The above arrangements are more or less standard, although variations exist depending upon circumstances.

The cooperation and close relations which have for some years existed between the United States and the other American republics were for a while not applicable to United States-Argentina relations. During the second World War and for a period after the war a certain amount of friction between the United States and Argentina marred hemispheric solidarity. Relations between the two countries improved materially in 1950. The United States extended a credit to Argentina of \$125 million in 1950 to help Argentina meet certain commercial difficulties which had become critical.

Relations between the United States and Mexico were somewhat slower to improve as a result of the newer United States policy begun during the 1930's, than in most of the other countries of Latin America. Mexico was carrying through a comprehensive program of economic and social reform which resulted in friction with property owners, both Mexican and foreign but particularly foreign. Mexican nationalism became a powerful influence following the 1911 revolution, and made matters especially difficult for foreigners and their businesses during the Cárdenas administration which took office in 1934. Under the program of agrarian reform, large estates, including holdings of United States citizens, were broken up and the land given to peasants. Although the Mexican constitution provides for compensation, owners were dissatisfied over the arrangements made for such compensation.

In 1938 the Mexican government expropriated foreign oil properties, which resulted in strong protests from the United States and British governments in view of the nature of the provisions for compensation. The oil companies contended that

the expropriation, like the agrarian reform, amounted to confiscation. The United States Treasury had in 1936 concluded an arrangement whereby it purchased practically all the newly mined Mexican silver. After the expropriation the Treasury immediately ceased purchase of this silver, although only two months earlier it had announced continuation of the silver buying arrangement.

In November, 1941, a series of agreements between Mexico and the United States dealt with some of the outstanding issues between the two countries. The United States agreed to open a credit to stabilize the peso, to buy silver each month, and to lend Mexico money for road construction. Mexico agreed to make payments in settlement of agrarian claims, and to the appointment of a joint board to appraise the oil properties. In 1942 a value of $23,996,000 was announced by this board, which was considerably more than that previously offered by Mexico. With the settlement of some of these outstanding issues, and regular payments by Mexico on the claims, relations between the two countries improved. They are now on a cordial cooperative basis.

In recent years the United States has extended substantial financial aid to Mexico which has made noteworthy progress in its economic development. Mexico devalued the peso in 1948 to a realistic level and avoided the imposition of exchange restrictions, which have been the source of difficulties in many of the other countries. Economic conditions in Mexico improved greatly following devaluation. Mexico, with its approximately 25,000,000 people, has benefited from the large amount of money spent there by United States tourists who have increasingly discovered the attractions and accessibility of Mexico.

Brazil, like other American republics, has made rapid progress in recent years in developing some of her extensive resources, modernizing her cities and improving conditions generally. Cities like Rio de Janeiro and Sao Paulo are among the most modern of any cities in the world. Brazil played an active role in the second World War, and was the recipient of substantial aid from the United States during and since the

war. A major steel mill, Volta Redonda, has been constructed and other industries developed. Joint United States-Brazilian commissions have surveyed the economic needs of Brazil and facilitated the economic development program which is now being implemented.

The other American republics have also made noteworthy progress in their economic development, although in the case of all countries much remains to be done. Venezuela, for example, aided by the income from large petroleum exports has forged ahead rapidly. All of the countries attach great importance to their programs of economic development and to the improvement of living standards which throughout large areas are still unsatisfactory and in urgent need of attention. In these programs of betterment which are now actively under way, the United States, along with international agencies, is participating extensively to the advantage of all concerned. United States-Latin American relations are now on a firm basis of mutual respect and understanding, although there still exist persons in these countries, as in other parts of the world, who from time to time, for political or other motives, raise the cry of "Yankee imperialism."

Chapter 36

OCEAN SHIPPING AND INTERNATIONAL AVIATION

Development of Modern Shipping.—The great expansion of foreign trade within the past century could not have taken place apart from the revolutionary developments in ocean transportation. About 75 per cent of foreign trade, according to volume, ordinarily moves by sea.[1] Until the nineteenth century all ocean commerce was transported by means of sailing vessels, which took several weeks to cross the Atlantic and were dependent on the vagaries of wind and weather. As early as 1775 a successful steam vessel had been built as an experiment, but it was not until the work of Robert Fulton in the first decade of the nineteenth century that the steamship showed signs of becoming a practical and profitable invention. Fulton's "Clermont," launched in 1807, succeeded in making the 150-mile journey up the Hudson River from New York to Albany in thirty hours, which excelled the performance of the best sailing vessels.

The first successful European steam vessel, the "Comet," was completed in 1812, and made regular trips between Glasgow and Greenock, Scotland. In 1819, the famous "Savannah," a steam-equipped ship, succeeded in crossing the Atlantic, although the voyage was made with the aid of sails. All the early steamships used sails for auxiliary power. The "Royal William," a Canadian steamer, is usually regarded as the first ship to cross the Atlantic by steam power alone, a feat which was accomplished in 1833. In 1838 the steamboat "Sirius" made the trip from Cork to New York in eighteen days, inaugurating transatlantic steamship service.

[1] League of Nations, *World Economic Survey, 1939/1941.*

A new era of ocean transportation was ushered in with the building of the "Great Western," completed in 1838. Designed for regular voyages between Europe and the United States, the 212-foot vessel attracted much attention and proved a success.

Meanwhile, other important developments were taking place. After much experimentation, the screw propeller was developed as a substitute for the paddle wheel, and was introduced in ocean vessels about 1840. Before many years this method of propulsion had completely replaced paddles in ocean transportation. A single propeller was used at first, but later twin-screw, triple-screw, and finally quadruple-screw ships became common.

About the same time that the screw propeller was being introduced, iron ships began to be constructed. The increasing size and speed of ocean vessels necessitated sturdier ships than could be built of wood. In 1843 appeared what may be called the first modern ocean steamship, the "Great Britain." Besides being screw-propelled and built of iron, this ship contained other important innovations which were widely adopted in later vessels. During the last two decades of the nineteenth century, steel rapidly replaced iron as a shipbuilding material. The old wooden sailing ships with their long history on the high seas were seen less and less.

Major improvements in ship design and construction have continued. Not only have new types of engines been developed, but the efficiency of the steam engine has been greatly increased. Until the twentieth century, steam engines used in ocean-going vessels were of the reciprocating type, utilizing pistons. While this type of engine had been developed to a high degree of efficiency, it had the disadvantage, when built in the large sizes demanded by a modern ocean liner, of causing troublesome vibration. During the 1890's, experiments were made in England to determine the practicability of employing the steam turbine in ocean transportation. This type of steam engine works on the same principle as the water-wheel, using jets of steam instead of water. The application of the steam turbine to ocean vessels was an immediate success. After being tried in smaller ships, the turbine was installed in the Cunard liner "Mauretania," launched in 1907, which held the Atlantic

speed record for over twenty years. In recent years improved boilers and increased steam pressures have made possible marked savings in fuel.

A conspicuous twentieth-century development has been the substitution of oil for coal as fuel. In 1914-15, according to *Lloyd's Register of Shipping,* only 1,310,000 tons gross of vessels were fitted with oil-burning boilers. By 1949 this figure had climbed to the total of 45,806,000 tons. The world tonnage of vessels that year, including motor-ships, was divided between oil-burning and coal-burning vessels in the proportion of 80.9 per cent for oil burners, and 19.1 per cent for coal burners.

While steam still holds unquestioned sway as the chief source of power for ocean-going vessels, other sources of power are increasing in importance. The rise in importance of Diesel engines has been particularly rapid. Vessels powered directly by Diesel engines are known as motor ships. The gross tonnage fitted with Diesel engines increased from 234,000 tons in 1917 to 19,352,000 tons in 1949. During this period extensive improvements in Diesel engines took place. Their weight was reduced at the same time that their power and efficiency were increased. Recent developments have been the supercharged four-cycle Diesel and the geared Diesel, both of which increase operating efficiency. Electric power has also been used for the propulsion of vessels. Generation of the electricity is generally accomplished by steam turbines, although Diesel engines are sometimes used for this purpose.

Improvements in design have accounted for increases in speed for all types of vessels. The typical cargo vessel of thirty years ago had a cruising speed of about ten knots per hour. The typical freighter built today betters this speed by four to six knots per hour. Well designed faster ships tend toward more over-all efficiency and economy than slower ones. A fifteen-knot ship will make several more trips per year than will a ten-knot ship. Many of the cost items are not increased by the extra speed, although fuel costs are greater.

The average length of time for Atlantic crossings on the faster vessels is continually growing less. The luxury liners have vied with each other for speed records. The ill-fated

French liner "Normandie" in August, 1937, was the first ship to cross the Atlantic in less than four days, making the westward passage from Bishop Rock, England, to New York in three days, twenty-three hours, and two minutes. The "Normandie" had previously taken the mythical blue ribbon from its rival, the "Queen Mary." Building and operating ships with a view to speed records, however, is a costly process. High speeds require a great deal more power and fuel.

Progress in shipping has been accompanied by improvements in ports for docking and for handling cargoes which have increased in size and weight. The cargo of a modern vessel would fill the holds of a dozen vessels of former years. A locomotive may be hoisted aboard and carried to a distant port. The Suez and Panama canals have shortened distances and thereby reduced shipping time and transportation costs. The many improvements in transportation have made possible the mass movements of commodities and the great increase in foreign trade of recent times.

Types of Vessels.—Ocean vessels vary greatly in design according to the purposes for which they are intended. The most impressive, although not always the most profitable type of vessel, is the large luxury liner, which specializes in the transportation of passengers, mail, and high-grade freight. The "Queen Mary," "Queen Elizabeth," "Liberté," and the new "United States" are among these vessels. Since a vessel of this type is built for speed, potential cargo space must be sacrificed to power plant and fuel tanks. The newer and more luxurious of these ships are booked to capacity most of the time. Although expensive to construct and to operate, liners of this type earn good profits during their first few years while they are new and popular. Considering the entire life of such vessels, they have frequently been unprofitable. The leading steamship companies have felt, however, that they must have at least one of these super-ships for the sake of prestige and advertising value, and as a means of attracting other business. Since the second World War practically all passenger vessels have been booked to capacity most of the time in view of the shortage of

such vessels, and have earned good profits. Competition from the airplane, however, has become an increasingly important factor for passenger vessels.

The carrying of passengers provides only a minor part of the income of total ocean shipping. While the cargo vessel, like the freight train, may be less spectacular than the large express liner or streamlined train, it is the freight carriers which earn the most money for their owners. Most of the vessels of the world are primarily or exclusively for the transportation of cargo. It is these vessels which carry the large volume of basic commodities and manufactured products which are vital to the economies of all countries. In between the passenger ship and the vessel designed solely for cargo are the combination passenger-and-cargo vessels, varying in size and speed. They ordinarily carry from about twelve to 100 or more passengers. A ship with no more than twelve passengers does not need to meet the standards imposed by United States law and international conventions for passenger vessels.

Ships of a specialized type, such as refrigerator vessels or oil tankers, are often owned by the company which produces the articles transported. The United Fruit Company, for example, owns a fleet of refrigerator ships which it operates in the banana trade between the United States and Central and South America. Several of the large oil companies have their own tankers. The bulk of ocean shipping, however, is carried on by independent operating companies.

Vessels operated without any regular schedule or fixed ports of call are known as "tramp ships" or "tramps." The tramp ship determines its course according to where cargo is located. The ship is thus free to take advantage of whatever profitable shipping opportunities appear. Tramp vessels are often leased by their owners to operators, sometimes for considerable periods of time. An operator, having rented a ship on a time basis, can proceed to charter it to individual exporters on a trip basis. Tramp ships give shippers similar service but compete for cargo on the basis of rates charged, whereas liners, which operate on regular routes, charge the same rates and compete in service.

Tramp shipping has declined in importance in recent years. This decline is partly because of the growth in the volume of foreign trade and the larger number of ports where a steady supply of goods is constantly awaiting shipment. It is also because of the increased need for regularity of shipment and freedom from delay and uncertainty. Consequently, much the larger portion of ocean shipping is now done by steamship lines which operate vessels on regular schedules between specified ports. In 1914 three-fourths of the world's ocean freight was carried by tramp ships, while by 1939 only about one-fourth of world shipping was done in this way. Only in Japan and Greece, where operating costs were low, did tramp tonnage gain in relative importance. During the war practically all ships were operated as tramps due to the exigencies of war. They were operated, however, under centralized direction. Since the war the tramp ship has again lost ground, although the extensive shipments of coal and grain under the foreign aid programs are being carried by tramps and on a specially lucrative basis. The United States had in 1951 only about 200 tramp ships under United States registry.

Trade Routes.—Most vessels, unlike tramps, travel back and forth over regular routes, trade routes, as the lanes are known. The location and direction of trade routes are governed largely by the location of the principal world ports and the population they serve. A trade route between two ports is ordinarily the shortest route, but the route may be lengthened to include additional ports of call. Winds and ocean currents may also cause some deviation. If there are no land obstructions between two ports, the shortest route is an arc of a "great circle" —i.e., a circle corresponding to the circumference of the earth.

Trade routes were considerably altered by the building of the Suez and Panama canals. These canals save thousands of miles and are of benefit to practically all the ports of the world. The Panama Canal saves 3,768 miles between New York and Yokohama, and 5,666 miles between Liverpool and San Francisco. The Suez Canal saves 3,409 miles between New York and Bombay, and 4,541 miles between Liverpool and Bombay.

The Suez Canal was opened in 1869, and is 104 miles long. Unlike the canal at Panama, the Suez Canal is a water-level canal without locks. The Panama Canal is fifty miles long, and was completed in 1914 at a total cost of over half a billion dollars. Additional sums have been spent in improving and enlarging it. Both of these canals have been successful, and have enjoyed continually increasing traffic.

Trade routes change with conditions, as when trade shifts from a port of declining importance to another which is growing in size and serving a developing hinterland. Wars, political changes, trade barriers, technological developments, growth of population and many other factors contribute to the location and shifting of trade routes. The development of an artificial harbor, such as that of Los Angeles, may alter trade routes.

The principal trade routes radiate from some thirty or more world ports. The most important route is that which connects western Europe and the North Atlantic ports of America. Over this line ordinarily flows more than one-sixth of the world's entire commerce, embracing a wide variety of goods. Ships from western Europe to the United States carry chiefly manufactured articles, textiles, and an assortment of goods originating in many countries. From the United States to Europe flow cotton, wheat, meat, petroleum products, metals, machinery, lumber, automobiles, and manufactures of many kinds. London has long been the principal entrepot of the world—a center from which goods imported are re-exported on an extensive scale.

A second major trade route proceeds from western Europe to the Panama Canal, whence it branches off to the Pacific ports of North America, to those of South America, and to Australia. Cargoes from Europe are much the same as those described above. Returning from the Pacific ports of South America, ships carry chiefly minerals, such as nitrates, copper, tin, lead, zinc, and oil; and tropical products—cacao, sugar, quinine bark, tanning materials, and some cotton and rubber.

A third route, connecting Europe with eastern South America, is also of importance. European products are transported over this route in exchange for coffee from Brazil, and meat, grain, hides, and wool from Argentina.

A fourth and much traveled European route leads eastward to Mediterranean ports, and through the Suez Canal to India, Ceylon, the East Indies, and Far East. European shipments are traded for rice, wheat, cotton, sugar, and jute from India; tea and graphite from Ceylon; rubber, tin, and copra from the Malay States; wool, meat, grain from Australia; silk, tea, and textiles from Japan and China under normal conditions.

A fifth European route proceeds from western Europe, particularly England, down along the western coast of Africa to Cape Town. The chief West African and South African products which return along this route are minerals, especially chromite, copper, gold, and diamonds; and tropical products, such as cacao, mahogany, ebony, and ivory.

Turning to the trade routes which center in the United States, the most important is the North Atlantic route to Europe, already mentioned. This route accounts for over half the tonnage which enters and leaves American ports. Other important Atlantic routes connect New York with Cuba and the West Indies, with eastern South America, with Central America, and, through the Panama Canal, with western North America, western South America, and the Far East.[2]

New York is far in the lead of other American ports, from the standpoint of the tonnage of exports and imports, with total foreign tonnage five or six times that of Boston and Philadelphia combined. New York ordinarily handles about one-third of American foreign trade. In the South Atlantic region Baltimore leads, with Charleston and Savannah also handling large tonnages. New Orleans, Galveston, and Houston are important Gulf ports.

Commerce in the Pacific region has been growing rapidly. From San Francisco, Los Angeles, and Seattle, trade lines extend to the Far East and South Pacific, often by way of Honolulu. The Atlantic and Gulf ports have an extensive trade with

[2] The United States Maritime Commission listed twenty-three trade routes from American ports in its Economic Survey of the American Merchant Marine, 1937. The Commission's Post-War Planning Committee recommended thirty-one routes as essential to United States commerce for postwar operations in its report published June 15, 1946.

the Far East which exceeds that of the Pacific Coast with the Far East. From American ports flow to the Far East manufactures, lumber, metals, and cotton; from China and Japan in normal times, come silk and textiles; from the Philippines, coconut oil, copra, and sugar. Rubber, tin and other products come from South East Asia. Wool is the principal export from Australia.

Rates and Steamship Conferences.—Ocean shipping is highly competitive, in contrast to the railroad industry which tends to be monopolistic. The competitive character of ocean shipping is due largely to the fact that the ocean is a free highway over which vessels of all types and nationalities can roam. Once on the seas, ships have to contend with similar factors.

The supply of ships cannot change rapidly, although vessels may be withdrawn from use when freight rates go down, and can be returned to service when rates rise. The demand for shipping services has been subject to wide and often irregular variations as a result of the seasonal character of certain industries, business fluctuations, trade restrictions, and particularly war, preparations for defense and changes in international political conditions. The fact that the supply of ships cannot be adjusted readily to the demand has tended to prevent ocean freight rates from showing much stability. During the first and second World Wars, freight rates were extremely high. Between the wars a supply of idle ships which could be placed in service tended somewhat to check rapid increases in freight rates.

The shipping industry has been susceptible to overbuilding with the result that much of the time during the past several decades, particularly in the case of United States shipping, the industry has not been very profitable, although during and since the second World War shipping has been exceptionally profitable. This condition of normally poor profits is partly due to the fact that ships, once built, last a long time, which fact contributes to the lack of flexibility in the supply of ships. Overbuilding is also partly the result of aid to shipbuilders and shipowners by subsidy policies of governments. The needs of the

first World War and the shortage of ships led to frantic building, causing an oversupply when the war was over. Rapid construction of ships during the second World War and the large tonnage sunk, particularly passenger vessels, caused a surplus of certain types of vessels, notably slow freighters, and a scarcity of others such as passenger vessels.

A shipping company which is not making a profit may continue to operate its vessels rather than to lay them up. The fixed charges of shipping companies are large, and many expenses—interest and depreciation, for example—continue whether ships sail or not. Any earnings that can be made toward these expenses are better than nothing. The lowest freight rate which a company can afford to offer in situations of this kind is that which covers operating expenses, or prime costs—the direct costs of moving boat and cargo, and which would not have been incurred had a trip not been made. Costs of this kind include fuel, loading and unloading, port dues, and wages of seamen. Rather than maintain a vessel idle it would pay a steamship company to accept freight rates only slightly above the operating expenses, although the company would show a deficit unless other costs were also met. Shipping companies are not alone in this type of situation.

In special cases operating expenses do not constitute the lower limit in the determination of freight rates. A tramp vessel may be leaving for a port where a highly profitable shipment is waiting. In the port that it is leaving only low-grade bulky freight may be available for shipment. The ship, needing ballast, might be willing to carry this freight for a rate barely in excess of the loading and unloading costs.

In order to check the tendency toward cutthroat and disorderly competition, which is particularly present in shipping where prime or direct operating costs are not as large a percentage of total costs as in certain other industries, steamship conferences, as they are called, have been formed. These are voluntary associations of steamship companies serving a particular route. The North Atlantic Steam Traffic Conference was organized in 1868 in New York by Sir Samuel Cunard. Other conferences were soon organized and at present practi-

cally all important shipping routes are covered by conferences. British lines have been especially active in the organization of conferences. There are today about 125 conferences involving United States ports, including about 300 steamship lines. With a few exceptions, the companies of no single country control the decisions of any conference.

The purpose of conferences is to regulate and limit competition between companies. The companies accordingly agree to maintain certain schedules of freight and passenger rates, and to cooperate in other matters. Slower vessels are usually allowed to charge lower rates than faster vessels. In some of the conferences earnings are divided among members on a predetermined basis. These arrangements are known as "money pools." There are also "traffic pools" in which the traffic is apportioned among the members rather than earnings.

Conferences over the years have had difficulties in enforcing their rules and in shutting out competition. The operations of nonmembers, and secret agreements between shippers and members in order to undercut conference rates have at times interfered. In periods of good business, conferences have sometimes disintegrated because of the lessened benefits they could confer on members.

The monopolistic aspects of conferences have caused them to be subject to criticism, to government investigations, and to a certain amount of government control. New steamship lines have not only been refused membership in a conference, but have at times been actively fought. Rebates have been offered to shippers for not patronizing a new line. There is, of course, a limit to the extent to which monopolistic practices are effective. If freight rates are unreasonably high, tramp vessels may appear on the scene and force rates down. Secret agreements are also encouraged by excessive rates. In order to keep shippers in line, conferences developed the deferred rebate system, according to which shippers who patronized only conference lines would be given a refund, usually 10 per cent, but only after the lapse of a certain time. A sum of money was thus held over the shipper's head to be sacrificed if he patronized another line,

even though the other line offered substantially lower rates or a sailing schedule that better suited his needs.

Conference practices were investigated in England by a Royal Commission in 1906 and by a United States Congressional Committee in 1912; also by the United States Department of Commerce in 1934, and by the Maritime Commission in 1939. The United States Shipping Act of 1916, preserved the conference system, exempting participants from certain features of the antitrust laws, but made illegal the deferred rebate system and certain other practices. Conference agreements must, according to this Act, be submitted for the approval of the government shipping authorities, and are subject to government supervision. Most of the conference abuses have thus now been eliminated. The principle of self-regulation underlies the system, and the government shipping authorities have exercised a minimum of control over rates and other conference affairs.

Conferences usually have the support of shippers, as brought out in testimony during investigations. Shippers desire stable rates so that they can make contracts with assurance. It is generally believed by shippers that conferences, properly controlled, promote stability in rates and service.

Government Subsidies to Shipping.—Many governments aid the building and operation of ships through subsidies or assistance of one kind or another. The reasons for the financial and other aid to shipping have to do with such things as the need for a large merchant marine in the event of war, the desire to possess ships so as to be independent of other countries, national pride in the possession of ships or the desire to afford protection to a country's shipping industry similar to that afforded by tariffs to other domestic industries. A merchant marine is also sometimes regarded as helpful in the development of foreign trade.

In the case of most countries, profits in the shipping industry, apart from profits during periods affected by war, have not been very good as noted above. Since the late 1930's practically all shipping companies have, of course, earned exceptionally good returns. If countries with high shipping costs and therefore not

well suited to shipping, desire to possess a thriving merchant marine, they have, under ordinary conditions, found it necessary to grant the industry substantial aid. With such aid shipping has often become quite profitable.

When a country subsidizes its shipping, other countries may be compelled to follow its example if they wish to retain their relative competitive status as shipping nations. The granting of subsidies thus tends to become cumulative. The United States Merchant Marine Act of 1936 provides that if aid paid to an American operator is inadequate to offset the effects of subsidies received by foreign competitors, a countersubsidy may be granted. Such countersubsidies, however, have never been granted.

Government aid to shipping takes a variety of forms. The principal of these are direct operating subsidies(also called subventions or bounties), construction loans at exceptionally low interest rates, cost differential subsidies on construction, lucrative mail contracts, requirements that certain cargoes be carried in ships under the country's flag, limitation of coastal trade to ships of domestic lines, and preferential railway rates on goods carried on domestic ships.

Great Britain, which for many years prior to the second World War ranked first in world shipping, attained this position with little aid to shipping. In recent years the British government has assisted those steamship lines which have been the most troubled with foreign competition, but Great Britain does not have an aggressive subsidy program. Its mail contracts with British shippers offer only a moderate payment above the actual cost of shipment. The government, however, has granted extensive construction loans, and has subsidized the operation of certain ships. The Trade Facilities Act of 1926 provided for loans to leading British industries, including shipbuilding. Prior to that time governmental loans at low interest rates had on occasion been extended to shipbuilders. In comparison to the subsidy programs of France, Italy, prewar Germany, and the United States, British aids to shipping have been moderate. Similarly, the subsidy programs of such leading maritime countries as Norway, the Netherlands and Greece are also moderate.

France has subsidized its shipping longer than practically any other nation. A large percentage of the present French merchant marine was built with government loans, and nearly all of it receives subsidies. The prewar German merchant marine, formerly independent but under Hitler largely owned by the government, depended upon substantial subsidies. The merchant marine of Italy is essentially owned and operated by the Italian government as was the case before the war. Japan, which before the war had a large number of ships, probably did not need to grant operating subsidies because of low wages and operating efficiency. Nevertheless, such subsidies were given. Shipbuilding was also aided. The United States has subsidized shipping generously inasmuch as the first World War, as well as earlier experiences, taught this country that it needed a merchant marine. The Merchant Marine Act of 1936 provided for direct subsidies in place of expensive mail contracts. United States subsidies are discussed in the next chapter.

Subsidies to shipping do not necessarily assure a nation that it will have a thriving merchant marine. Low costs are more important to this end than government assistance. Great Britain prior to the war, was carrying about two-thirds of its own foreign trade and about 45 per cent of the entire world's ocean trade, principally because it had a comparative advantage and consequently low costs in shipping. Japan's strong position was also not due to government aid. Nevertheless, government assistance can bring into existence a large merchant marine as United States experience has shown.

A policy of government aid to shipping may be necessary on security grounds, as in the case of the United States since adequate shipping must be assured for defense. On other grounds, however, the case for such aid is largely untenable. Aid beyond that needed for defense purposes is similar to other types of artificial support or restrictions which tend to distort production and trade, to interfere with the advantages of competition, and which are inconsistent with the most effective use of resources. Moreover, aid extended in the form of discriminatory laws and cargo preferences has other undesirable consequences. It reduces the pressure on ship operators to compete in rates and

service, and antagonizes foreigners often leading to retaliation. To the extent that aid is needed, outright subsidies are the most effective and do the least violence to economic considerations.[3]

World Shipping Since 1914.—The first World War, beginning in 1914, created serious maladjustments in shipping, an immediate result being a shortage of merchant vessels. Part of the shortage was due to the destruction of ships by submarines, and part to the withdrawal of vessels for military purposes. Since ships were vital to the Allied powers, ship construction was undertaken on an unparalleled scale. When the war was over, shipping participated in the short-lived boom as nations, unable to obtain goods during the war, now placed large orders. Because of the strong demand for cargo space, together with the destruction of ships, tonnage was relatively scarce. About 21,000,000 deadweight tons were lost during the war. Allied and neutral new construction amounted to about 14,000,000 tons. Shipbuilding therefore continued after hostilities, and freight rates remained at high levels for over a year after the Armistice.

The result of this situation was overbuilding of ships. By 1921 the American merchant marine engaged in foreign trade stood at slightly over 11,000,000 deadweight tons, compared with only 1,000,000 deadweight tons in 1913. In spite of the high construction costs, all the shipbuilding nations continued to build ships. Germany, which had not only been divested of its merchant fleet by the Treaty of Versailles, but had been obliged to build ships for the Allied powers, proceeded energetically to rebuild its own merchant marine. In a few years Germany's prewar tonnage was largely replaced. By the end of 1923, when the volume of international trade was about 15 per cent less than before the war as a result of the sharp depression, the volume of ocean tonnage was over 40 per cent greater.

An immediate effect of the extensive building program, coupled with depression in trade, was an inevitable collapse in

[3] The question of subsidies is discussed further in the next chapter, United States Shipping Policies.

freight rates[4] and a large amount of idle shipping. In 1923 idle tonnage amounted to approximately 8,000,000 tons, half of which belonged to the United States. Nevertheless, total world tonnage, spurred on by government subsidies, continued to increase notwithstanding considerable scrapping of vessels. By 1929 the registered tonnage of the world amounted to 65,600,000 tons, an increase of almost 50 per cent over that of 1913. The volume of world trade for 1929 was only one-fourth greater than before the war. It is not surprising that in this year of prosperity, ocean freight rates remained depressed.

Accompanying the depression of the thirties, maladjustments in shipping became more apparent. Few industries suffered more from the depression than did shipping. The distress was due not only to the collapse in world trade, but to a continuation of shipbuilding under governmental stimulus. Governments continued or increased their financial assistance to shipbuilders. In the summer of 1932, the low point in the depression, about one-fifth of the world's tonnage, or approximately 14,000,000 tons, was idle. Most ships that were operating were carrying only partial loads.

Little improvement occurred until about 1935, when an increased demand for raw materials caused the outlook for shipping to brighten. The improvement during 1936 and 1937 was particularly noticeable, being reflected in a rapid rise in freight rates and less idle tonnage.[5] The improvement accompanied general economic recovery throughout the world and also reflected demands of the rearmament programs of the leading nations. Reduction of some of the trade barriers also assisted in the revival of world trade and shipping. The emergence of new markets, as well as the revival of old, aided shipping during the last half of the 1930's. Industrial developments in eastern Asia, Africa, and parts of South America created new demands for coal, oil, copper, and steel. American exports of automo-

[4] According to the index of the *London Economist*, ocean freight rates dropped from 594 in February, 1920 to 110 for the year 1923 (1913 = 100).

[5] According to the index of the *London Economist*, tramp freight rates increased from 76.3 in May, 1936, to 133.1 in May, 1937.

biles, electrical equipment, and machinery returned to levels of the previous prosperous years.

Improvement in the shipping industry prior to the second World War was aided by the extensive scrapping of obsolete vessels. In 1934 Great Britain inaugurated a "scrap-and-build" campaign. The government provided subsidies for the building or modernizing of ships, on the condition that for every ton of new shipping built, two tons of existing shipping be scrapped, and that for every ton modernized one obsolete ton be scrapped. The result was that while British tonnage declined to some 3,000,000 tons less than the amount in 1930, it was much more efficient and economical.

The outbreak of war in 1939 radically altered the world shipping situation, creating an intense demand for ships. American vessels were prevented by the United States Neutrality Act, until amended in November, 1941, from carrying on trade with European belligerents. Nevertheless, American shipping prospered because of exceptionally heavy trade with areas not affected by the neutrality legislation.

In 1939 the world's merchant marine totaled 68,500,000 gross tons, having increased from 43,100,000 tons in 1913. The 1939 figure almost equaled the peak of 68,600,000 tons reached in 1931. Great Britain commenced the war with a total of about 21,000,000 gross tons of shipping, including Dominion shipping. The losses from German attacks were not serious until after Dunkirk when sinkings mounted rapidly, and were especially severe during 1941 and 1942. The speed and efficiency of ships were necessarily reduced to adapt to convoys and other wartime conditions. Vessels also had to travel greater distances between ports.

The United States on June 30, 1939, possessed an ocean-going merchant marine of 8,135,000 gross tons consisting of 1,398 vessels. Of these, however, only 319 vessels, representing 2,094,000 tons, were engaged in foreign trade. Approximately 1,750,000 tons, 306 ships, were laid up. The situation was materially better than at the outbreak of the first World War, when this country had only about 1,000,000 tons. The Merchant Marine Act of 1936 was designed to rehabilitate the

country's shipping position which had continuously deteriorated since shortly after the end of the first World War. The Maritime Commission, created by the Act, had by 1939 started the construction of a large number of ships, but few of these were then completed. When the United States entered the war in 1941 the construction program was greatly expanded. The American merchant marine is discussed in more detail in the next chapter.

The end of the war in 1945 found the world shipping picture materially altered from what it had been in 1939. The merchant fleets of Germany, Italy and Japan, all important maritime nations, were largely sunk or captured. The vessels of the Scandinavian countries had suffered severely as had those of France, Belgium, and the Netherlands. British losses had been extensive, but wartime construction of ships had been pushed energetically. The United States as a result of the extensive building program during the war, was far out in front in spite of heavy losses. The United States vessels were largely freighters and many of them of slow speed. Losses of passenger vessels had been especially great, and the postwar period witnessed a world shortage of passenger vessels. The demands from passenger travel were at the same time heavy. Due to the high cost of passenger vessels, new construction, while it relieved the pressure somewhat, did not provide enough vessels to meet the demands.

Following the Korean War which began in June, 1950, the demands for ships increased, reflecting defense and rearmament needs. Unusually large coal exports from the United States to South America and to Europe added to the demand for ships. Freight rates rose sharply. World trade in general expanded, and a large number of idle ships were reactivated. The United States sought to expand its shipbuilding facilities so that ship construction could readily be increased in the event of war.

Table 15 shows the shipping situation in 1950 when total world shipping amounted to 13,050 vessels of 105,299,000 deadweight tons.

International Aviation.—The development of aviation and of air routes that cross national boundaries has created a num-

TABLE 15. Merchant Fleets of the World as of June 30, 1950

Seagoing Steam and Motor Merchant Vessels of 1,000 Gross Tons and Over

(Excludes vessels on the Great Lakes and inland waterways and special types such as channel vessels, icebreakers, cable ships, etc. and merchant vessels owned by any military force)

(Tonnage in thousands)

Flag	Total			Combination Passenger and Cargo			Combination Passenger and Cargo Refrigerated			Freighters			Freighters-Refrigerated			Bulk Carriers			Tankers		
	No.	Gr. Tons	DWT.	No.	Gr. Tons	DWT.	No.	Gr. Tons	DWT.	No.	Gr. Tons	DWT.	No.	Gr. Tons	DWT.	No.	Gr. Tons	DWT.	No.	Gr. Tons	DWT.
Total—All Flags	13050	74999	105299	1031	7356	5824	74	792	690	9065	47118	69027	253	1536	1736	556	1716	2762	2071	16481	25261
United States *	3516	26114	37478	77	820	612	7	49	33	2847	20248	28896	46	273	285	58	357	676	481	4368	6976
British Empire	3109	18869	25132	333	2882	2125	51	644	567	1865	9940	14690	102	897	1044	231	558	859	527	3947	5846
United Kingdom	2586	16571	22018	232	2466	1800	49	632	560	1507	8338	12312	100	889	1037	203	471	726	495	3774	5585
Canada	167	910	1221	27	89	36	1	8	5	116	665	958	—	—	—	—	—	—	23	146	222
Australia	120	430	590	17	101	72	—	—	—	85	268	424	—	—	—	18	60	94	—	—	—
New Zealand	49	153	170	8	37	12	1	4	3	33	96	134	—	—	—	6	14	20	1	1	1
India	75	367	536	15	68	80	—	—	—	57	286	435	—	—	—	2	10	16	1	3	5
Union of South Africa	18	116	167	1	10	12	—	—	—	16	96	138	—	—	—	—	—	—	1	10	17
Pakistan	9	49	76	—	—	—	—	—	—	8	46	70	—	—	—	—	—	—	1	3	5
Colonies	85	273	355	33	110	114	—	—	—	43	145	219	2	8	8	2	3	4	5	8	10
Argentina	124	718	980	14	96	76	1	10	13	68	390	584	4	10	12	3	5	7	34	208	288
Belgium	80	416	588	11	92	99	1	7	10	55	234	361	2	5	4	2	3	5	9	75	109
Brazil	158	598	820	30	123	124	—	—	—	115	434	640	—	—	—	4	5	6	9	35	50
Bulgaria	3	9	14	—	—	—	—	—	—	3	9	14	—	—	—	—	—	—	—	—	—
Chile	42	160	212	8	35	40	—	—	—	20	81	108	—	—	—	14	44	63	—	—	—
China	178	559	738	18	53	38	—	—	—	128	424	585	2	6	9	6	12	18	24	64	88
Colombia	10	29	39	—	—	—	—	—	—	8	25	34	—	—	—	—	—	—	2	3	5
Costa Rica	1	1	2	—	—	—	—	—	—	1	1	2	—	—	—	—	—	—	—	—	—
Cuba	10	25	33	1	2	2	—	—	—	9	22	31	—	—	—	—	—	—	—	—	—
Denmark	303	1082	1605	26	84	76	2	2	3	233	783	1199	11	23	33	11	24	38	20	164	256
Dominican Republic	2	5	4	1	3	2	—	—	—	1	2	2	—	—	—	—	—	—	—	—	—
Ecuador	5	14	20	1	1	1	—	—	—	3	12	17	—	—	—	—	—	—	1	1	2
Egypt	23	93	104	11	48	54	—	—	—	10	38	38	1	2	4	1	4	8	—	—	—
Estonia	15	25	35	2	3	2	—	—	—	9	15	23	—	—	—	4	7	10	—	—	—
Finland	171	440	676	4	8	4	—	—	—	153	369	578	—	—	—	7	17	26	7	46	69

	No.	Gr. Tons	DWT.	No.	Gr. Tons	DWT.	No.	Gr. Tons	DWT.	No.	Gr. Tons	DWT.	No.	Gr. Tons	DWT.	No.	Gr. Tons	DWT.	No.	Gr. Tons	DWT.
France	511	2825	3595	68	616	401	3	30	25	293	1348	1972	20	71	64	56	181	256	71	579	878
Germany	89	235	359	4	17	22	—	—	—	71	164	257	—	—	—	10	24	36	4	29	45
Greece	227	1268	1933	11	52	35	—	—	—	193	1090	1695	—	—	—	10	30	51	13	97	152
Honduras	89	500	708	2	5	3	4	18	15	57	268	398	14	57	51	—	—	—	12	151	242
Hungary	1	1	1	—	—	—	—	—	—	1	1	1	—	—	—	—	—	—	—	—	—
Iceland	13	31	36	3	7	4	1	2	2	9	23	31	—	—	—	—	—	—	—	—	—
Iran	1	7	10	—	—	—	—	—	—	1	7	10	—	—	—	—	—	—	—	—	—
Ireland	13	38	56	—	—	—	—	—	—	10	26	37	—	—	—	3	12	19	—	—	—
Israeli	19	82	108	3	13	10	—	—	—	16	69	98	—	—	—	—	—	—	—	—	—
Italy	406	2413	3382	46	376	309	1	11	9	272	1441	2163	3	13	14	11	47	78	73	525	810
Japan	308	1214	1766	23	99	99	—	—	—	250	896	1342	3	22	33	2	4	5	30	193	288
Korea	3	6	9	2	3	4	—	—	—	1	3	5	—	—	—	—	—	—	—	—	—
Latvia	9	19	30	—	—	—	—	—	—	9	19	30	—	—	—	—	—	—	—	—	—
Lebanon	1	3	4	—	—	—	—	—	—	1	3	4	—	—	—	—	—	—	—	—	—
Liberia	21	286	485	—	—	—	—	—	—	4	19	31	—	—	—	—	—	—	17	267	453
Mexico	21	106	156	—	—	—	—	—	—	6	17	19	—	—	—	1	5	8	14	84	129
Netherlands	493	2775	3672	89	635	596	—	—	—	299	1585	2291	1	2	3	2	8	13	102	546	768
Nicaragua	3	6	10	—	—	—	—	—	—	3	6	10	—	—	—	—	—	—	—	—	—
Norway	945	4988	7567	27	108	82	2	4	2	607	2330	3635	19	62	68	17	40	63	273	2445	3716
Panama	485	3417	4984	26	213	167	1	15	11	235	1297	1815	4	18	22	27	87	150	192	1786	2819
Peru	19	77	102	4	22	24	—	—	—	12	48	67	—	—	—	1	3	5	2	5	7
Philippines	21	81	112	3	8	7	—	—	—	15	60	86	—	—	—	2	3	5	1	10	14
Poland	39	145	196	1	14	6	—	—	—	31	110	163	1	4	3	5	10	15	1	6	9
Portugal	90	388	527	20	129	121	—	—	—	64	219	345	—	—	—	—	—	—	6	41	61
Rumania	4	18	16	2	10	4	—	—	—	2	8	12	—	—	—	—	—	—	—	—	—
Siam	2	3	4	—	—	—	—	—	—	1	1	2	—	—	—	—	—	—	1	1	2
Spain	269	947	1316	35	159	135	—	—	—	197	614	939	—	—	—	13	36	54	24	138	189
Sweden	539	1794	2705	30	185	183	—	—	—	415	1059	1690	9	34	40	42	160	245	43	357	549
Switzerland	12	47	73	—	—	—	—	—	—	10	35	55	—	—	—	—	—	—	2	12	18
Turkey	101	348	469	25	102	92	—	—	—	68	212	325	—	—	—	2	4	5	6	30	47
Uruguay	11	70	104	2	10	12	—	—	—	7	39	60	—	—	—	—	—	—	2	21	33
U.S.S.R.	437	1365	1824	63	308	237	—	—	—	322	866	1315	11	38	47	10	20	32	31	134	193
Venezuela	48	134	179	3	4	4	—	—	—	9	24	30	—	—	—	—	—	—	36	106	145
Yugoslavia	47	197	316	2	10	12	—	—	—	43	177	287	—	—	—	1	4	8	1	6	9
Unknown	3	6	8	—	—	—	—	—	—	3	6	8	—	—	—	—	—	—	—	—	—

* Includes United States Government owned vessels transferred to foreign flags under lend-lease or other agreements and still remaining under these registries.
Note: Individual tonnages are not additive, since the detail figures have been rounded to the nearest thousand.
(Source: U. S. Maritime Administration.)

ber of international problems. These problems center around the question of the extent to which planes have the right or may be allowed to fly over the territories of foreign nations, to land, to discharge, and to pick up passengers and cargo there. The field is a new one for international law, and is requiring the working out of new principles and arrangements.

The principle has now been generally accepted that nations have the sovereign right to control the use of the air lanes over their territories. Freedom of the air thus does not exist in the same sense as freedom of the seas. The air space over a country is not considered an international highway like the high seas, but is similar to a country's territorial waters. Freedom to enter it may be accorded like freedom to enter a port. However, it is well-nigh impossible for a country to control completely the use of the air over its territories, especially in view of the increasingly high altitudes and speeds of planes.

The doctrine of freedom of the seas went through a long period of controversy before it was finally accepted. Wars were fought over the question as nations endeavored to close off large areas of the seas to all but their own ships. In 1604 Hugo Grotius argued in a Dutch court that no nation had the right to preempt the high seas and close it to the trade of other nations. In England his argument was vigorously opposed. It was not until 1805 that Great Britain formally abandoned her position against freedom of the seas.

The problem of the use of the air lanes has a short history. It was in 1927 that regular flights between Miami and Havana were commenced by Pan American Airways. Flights were soon extended throughout the Caribbean and to South America. British and Dutch lines had already been pioneering flights in Europe and to India and the Dutch East Indies. In 1935 Pan American Airways opened a line across the Pacific by way of Hawaii and other islands to the Philippines, China, and later to Australia. Trans-Atlantic flying posed difficult technical and also political problems. European nations were reluctant to see regular flights commenced until their planes were prepared to participate. It was not until 1939 that regular trans-Atlantic

flights were inaugurated. The route was by way of the Azores to Lisbon. Flying developed rapidly during the second World War and the years immediately following, until today practically all parts of the world are served by regular flights.

During the early period when flying was an interesting novelty nations issued permits to foreign planes readily and with little formality. It was later, when numerous and regular flights were being made and when competition had developed, that the problems arose.

A number of international conferences have been held to consider aviation problems, the first being the International Convention for Air which met in Paris in 1919, and which established a commission of participating countries, eventually thirty-three, which met semiannually. Its meetings were concerned largely with technical matters, and gave little or no attention to some of the more recent major problems. Before the war two international agreements on civil aviation were in force, the Paris Convention of 1919, and the Havana Convention of 1928, both inadequate to postwar needs.

The first major attempt to obtain international agreement of a comprehensive kind on the use of the air lanes was in 1944. At the request of Great Britain the United States called a conference on civil aviation which met in Chicago in November and December, 1944. At this conference the Canadians separated the question of international air commerce into five parts, which have come to be known as the "Five Freedoms." These are:

1. Freedom for commercial planes to fly over the territory of another country (Such planes could, consistent with this freedom, be required to follow certain lanes for purposes of safety or military security.)
2. Freedom to land at agreed ports for refueling or repairs, but not to receive or discharge passengers
3. Freedom to carry passengers and cargo from the plane's home country to any other country
4. Freedom to carry passengers and cargo from any other country to the plane's home country

5. Freedom to carry passengers and cargo between any other countries. An American plane from New York to Paris, stopping at London could thus carry traffic from London to Paris

These freedoms together, it can be seen, would provide rights in the air similar to those which ships enjoy at sea.

At the Chicago conference the United States argued for a free trade approach to use of the air and supported the Five Freedoms. The first two freedoms, dealing with transit matters rather than traffic, did not meet serious opposition, but the last three were the subject of controversy. The first two freedoms were embodied in an International Air Services Transit Agreement which has now been accepted by a large number of countries. The last three freedoms, which deal with the carrying of passengers and cargo, were incorporated in an International Air Transport Agreement, which was sponsored by the United States. This agreement, however, was not accepted and the United States finally renounced it in 1946. Subsequent efforts to obtain a multilateral exchange of rights have been unsuccessful, and the main problems have centered around bilateral bargaining for routes, traffic, etc.

The United States now operates on the basis of bilateral agreements made with individual countries, and through permits which it issues to foreign air lines. The agreement with the United Kingdom, known as the Bermuda Agreement of 1946, provides for certain reciprocal services, fixes routes, establishes machinery for the review of rates and sets forth certain principles regarding capacity. The United States has made about forty of these bilateral agreements. This system, however, is somewhat insecure since the agreements may be canceled upon one year's notice.

With the development of aviation and the expansion of routes, countries which do not engage extensively in aviation have, nonetheless, become increasingly aware of the importance of the right to fly over their territories, and of the bargaining position which they possess through the right to control the air. They are tending away from the fifth freedom, and desire recog-

nition of the principle that they can reserve to themselves traffic to which this freedom applies (when they are one of the "other" countries). United States companies engaged in international aviation receive substantial revenue from traffic between other countries, and may eventually be harmed if fifth freedom traffic is denied to them.

The strong position of the United States in the construction and operation of airplanes, partly an outgrowth of the war and of the postwar international uncertainty, gave the United States a competitive advantage as compared to other countries. The strong position of the United States in aviation has been reflected in the approach of this country, and also of the other countries, to international control over aviation. The United States has been less afraid of competition, and has promoted in general a policy of equal opportunity. Such an approach, while in the United States interest, rests on firm economic grounds, and is consistent with basic United States foreign economic policy as sought in trade, investment, and other fields. It conforms with this country's belief in the advantages to the United States and other countries of liberal trade policies and the free enterprise system.[6] While the United States has obtained favorable operating rights abroad, based heavily upon fifth freedom rights which are so important for long trunk route operations, this country has been criticized for not granting similar favorable rights to foreign carriers.

Some countries that are fearful of foreign competition, particularly from the United States, have sought the protection of international machinery which would restrict such competition. Thus at Chicago in 1944 the British and other countries argued for an international body with authority to regulate routes, frequencies of flights, rates, and capacities. The United States argued that equality of allocation of air rights was neither desirable nor feasible, since many countries were not in a position to enter the air. Equality of opportunity, the United States held, was not only the most feasible, but was the sound economic approach in the interests of progress, efficiency, and safety.

[6] See Chapter 34.

More recently these countries have sought to restrict operations within the framework of bilateral agreements.

As a result of the Chicago conference the International Civil Aviation Organization (ICAO) was established. This organization, although it has powers with respect to certain technical matters, has only advisory powers regarding economic and political matters. The United States has agreed nonetheless to support advisory opinions of ICAO with respect to frequencies, rates, capacities, and certain other economic matters.

In 1947 a conference was held in Geneva, called by ICAO, and undertook to draft a multilateral agreement for international aviation. The United States was favorable to such an agreement along the lines of the Bermuda Agreement, but was unwilling to include authority to regular routes, which it believes should be arranged bilaterally. At Geneva the United States and the European countries which were engaged in extensive aviation activities urged that when a route was agreed to, the countries on the route should permit fifth freedom traffic, i.e., traffic between foreign countries. Agreement could not be reached on this issue, however, which was largely the reason why no agreement came out of the Geneva conference. International aviation is thus today governed largely by bilateral agreements.

The United States and other countries subsidize their commercial aviation extensively, which fact introduces additional complications into the aviation picture. These problems are similar to those discussed with respect to shipping. Unless shipping subsidies and aviation subsidies are coordinated, a subsidy to one form of transportation may take traffic from and weaken the other form of transportation. United States aviation is controlled by the Civil Aeronautics Board created by Congress and to a large extent divorced from the executive branch of the government.

Chapter 37

UNITED STATES SHIPPING POLICY

Early History of United States Shipping.—The history of American shipping, which goes back to Colonial times, is a story of successes and reverses, of rapid rises and equally rapid declines. The first vessel built in America, the "Virginia," was launched in 1607 in the Kennebec River in what is now Maine. Shipbuilding increased and Yankee clipper ships, famous for their speed and grace, soon were a familiar sight in ports all over the world. They were so fast that they received special freight premiums by shippers of other nations.

During the Napoleonic wars the United States expanded its shipping rapidly, as discussed in Chapter 3. The dominant position which this country came to occupy in shipping during this period was not merely because European nations were otherwise engaged, but also because of the natural advantages in shipping possessed by the United States. With the depression and decline in foreign trade which came after the Napoleonic wars, American shipping suffered, but only temporarily. Until the Civil War, the United States was a leading shipping nation.

A number of reasons accounted for American preeminence in shipping during these early years. In the first place, the North Atlantic coast contained large supplies of excellent timber and other materials needed for shipbuilding purposes, thereby placing the United States in a position of comparative advantage in an era of wooden ships. The North Atlantic region, moreover, was not as well suited to agriculture as were the lands further south and west. The early settlers, also, were dependent upon water transportation, many localities having no other means of communication. Many of the newcomers from England and elsewhere were skilled in the operation and building of ships.

Thus shipping and shipbuilding, which offered about as good returns as could be secured in any field of endeavor in this country, prospered. The abundant and diversified opportunities, which were later to be characteristic of American industry, had not yet emerged.

The Civil War put an abrupt end to the prominent position of America in world shipping. Some vessels were lost, but a larger number was transferred to foreign flags in order to avoid the high war-time insurance rates, and also to avoid actual war risks. Although it appeared on the surface that the destruction and demoralization produced by Confederate preying on vessels were the principal causes for the decline, the real reasons ran deeper. In the first place, the era of wooden ships was over. The substitution of iron for wood took place rapidly during the sixties and seventies, and in the building of iron and later steel vessels, American costs were much greater than those of Great Britain. A statute adopted in 1789 forbade the United States flag to foreign-built vessels, so American operators were compelled to buy domestically built ships and to pay high prices for them. Furthermore, sailing vessels gave way to steamships, which development also damaged America's position in shipping. Between 1860 and 1870, British merchant tonnage increased from 5,710,000 to 7,150,000, and of this latter figure, 1,113,000 tons were propelled by steam.

Important also in the decline of America's shipping was the fact that the rapid and profitable industrial development of the United States which followed the Civil War, together with the completion of transcontinental railroad systems and the westward expansion, created opportunities for greater returns for the investor than could be obtained from ocean shipping. In other words, America had lost most of its comparative advantages as a shipbuilding and ship-operating nation.

The extent of the decline was great. Whereas in 1830, 90 per cent of American foreign trade was transported in American vessels, only 35 per cent was thus carried in 1870, and only 9 per cent in 1900. In the fifty years of unparalleled industrial expansion from 1860 to 1910, American shipping tonnage en-

gaged in foreign trade not only failed to increase, but dropped from 2,300,000 tons to 783,000 tons.

United States Shipping and the First World War.—The first World War, like the Civil War, marked a sharp change in the fortunes of the American merchant marine, but in an opposite direction. The beginning of the war found the United States with practically no merchant marine, while ten years later this country possessed a substantial fleet of ships. When the war commenced, European nations called home their ships, using them for war purposes, with the result that American foreign trade was suddenly left without adequate shipping. Freight piled up on the docks and the United States realized that its long discussed need for a merchant marine was now urgent.

The Shipping Act of 1916, discussed below, was directed especially to this country's need for ships. The United States Shipping Board, provided for in the Act, was created principally for the purpose of developing a large American merchant marine and naval auxiliary. With the entry of the United States into the war in the spring of 1917, the Shipping Board created the Emergency Fleet Corporation (later called the Merchant Fleet Corporation), with a capital of $50,000,000. All stock in this organization was owned by the government, with the exception of a small number of shares held by the trustees to enable them to qualify for their posts.

The Emergency Fleet Corporation undertook a huge program of ship construction. Between 1917 and 1922, the United States launched 2,316 hulls. Most of these were built at the Hog Island shipyard near Philadelphia. When the United States entered the war, Hog Island was merely a swamp on the Delaware River. Work was commenced in September, 1917, and a year later Hog Island had 30,000 workers, 250 buildings, eighteen miles of road, and eighty miles of railroad track. Its first ship was then afloat and being outfitted for service. Such rapid construction could not be accomplished without heavy cost. The government thus went wholeheartedly and expensively into the business of building and operating ships. The government

spent in connection with the first World War, over $2.5 billion in building ships.

As a result of intensive construction, the Emergency Fleet Corporation in a period of a few years transformed the American merchant marine into one of the largest in the world. But the ships were not available in time to be of much help during the war. The United States was dependent upon ships of the Allied nations for the transportation to France of its men and supplies. In 1921 the Shipping Board owned 1792 vessels with over 11,000,000 dead-weight tons.

In 1917, the United States seized the German ships that had been tied up in New York when hostilities began. The largest and most spectacular of these was the "Vaterland," only four years old, and the largest ship then afloat. The German crew had endeavored to make the ship unusable by damaging her engines, throwing vital parts overboard, and destroying blueprints. However, within a few months the ship, renamed the "Leviathan," was en route to Europe with some 10,000 American troops. After the war, the vessel was reconditioned by the Shipping Board and became a passenger liner, later passing into the hands of the United States Lines, and losing this company considerable money. In 1934 the ship was tied up, and in 1938 proceeded to Great Britain to be broken up for scrap.

When the war was over, the Shipping Board followed the policy of selling to private companies the vessels under its control, the aim being to foster a privately owned American merchant marine. These ships were sold at relatively low prices. By 1932, the Shipping Board's fleet had been reduced to 361 vessels of 3,087,000 dead-weight tons. Part of this government-owned tonnage was operated by private companies under government control, but a large portion remained idle.[1] Many of the hastily constructed wartime ships were broken up and sold for scrap.

[1] Most of these companies operated freight vessels. The most prominent of them, the United States Lines Company of Nevada, operated a fleet of government-owned passenger vessels in the trans-Atlantic trade, including the famous "Leviathan." A vessel of smaller and more economical type, the America, was designed in 1937 to take its place, and was placed in service along with other new vessels shortly before the outbreak of the second World War.

Immediately after the first World War there was a shortage of vessels, as a result of the expansion of foreign trade and the large postwar demand for goods which had been previously unavailable. After a few years, however, when trade had declined, the shortage of vessels changed into a surplus. American ship operators then had to contend with inadequate cargoes and also with foreign competition.

The shipping business suffered severely from the decline in foreign trade during the depression of the 1930's, and in 1937 some 162 government-owned vessels were idle, anchored at Norfolk, Staten Island, New Orleans, and other ports. Many of these idle vessels were obsolete and were in a badly run-down condition.

From shortly after the first World War until about 1937 the American merchant marine continuously deteriorated. As a result primarily of the extensive scrapping of vessels, American merchant tonnage declined rapidly from its peak reached a few years after the war. Whereas in 1921, more than 11,000,000 tons of American ships were engaged in foreign trade, in 1936 this had declined to only 3,250,000 tons. In 1939 the figure was 2,094,000 tons. The proportion of America's foreign trade carried in American vessels, which had increased from about 10 per cent in 1910 to 51 per cent in 1921, by 1930 had fallen to 35 per cent, and when the war began in 1939 to 23 per cent. However, under the Act of 1928, which aided the construction and operation of ships, about thirty good combination vessels had been constructed and were in operation.

The relative position of the United States among shipping nations likewise declined in the years following about 1921, especially since the United States merchant marine was rapidly becoming obsolete. On the basis of twenty years as the normal useful life of a vessel, about ninety per cent of the 1939 merchant marine was within two or three years of the scrap heap. When the war began, 49 per cent of United States tonnage exceeded twenty years in age. On the basis of ships less than ten years old, the United States ranked eighth. On the basis of ships that could make twelve knots or better, the United States was fifth. The advantages which the first World War had given the Ameri-

can merchant marine had thus to a large extent been allowed to lapse.

United States Shipping and the Second World War.—In spite of the deterioration in the country's shipping during the twenties and first part of the thirties, the second World War nevertheless found the United States better prepared with respect to its merchant vessels than in 1914. The United States ocean-going merchant marine on June 30, 1939, totaled 1,398 vessels of 8,135,000 gross tons. During the first eighteen months of the war and before the United States entry, 430 ships of all types, 1,489,000 gross tons, were transferred to foreign registry or ownership.[2] Most of these vessels were privately owned. The war provided shipowners an opportunity to dispose of obsolete ships at good prices. By October, 1940, largely as a result of transfers to foreign registry, the government-owned, laid-up fleet had declined to sixty-three vessels, most of these remaining vessels being of slight commercial value. Nevertheless, during the second World War they were repaired and put into active service, proving very useful.

The Maritime Commission, created by the Act of 1936 as noted below, had inaugurated a new construction program in October, 1937. This program, which was slow in getting under way, was speeded up as a result of the war, especially after the United States entered the war in December, 1941. At the time of Pearl Harbor 112 new vessels had been constructed at a cost of $298 million, and 771 costing $1,751 million were under construction.

The need for ships was urgent in view of the extensive sinkings by German submarines, and the large number of ships required to carry troops and their supplies. Ships were also needed to carry additional raw materials needed by the United States. Because of the submarine danger, ships were compelled to travel in convoys and were thereby delayed in port and slowed down en route. They were also compelled to travel longer distances to reach a given port.

[2] Britain received 182 of these ships of 648,000 tons, while twelve Latin American countries took 136 ships of 510,000 tons.

In view of the pressing need for ships the United States expanded greatly its shipbuilding facilities. The demands for additional merchant shipping came at a time when naval requirements were also great, and when the largest naval building program ever undertaken by the United States was underway. In order to expedite ship construction standardized designs were developed and mass production methods introduced. The principal type of cargo vessel built was the so-called Liberty ship, 427 feet in length, with a speed of eleven knots, and 10,500 dead-weight tons. The United States spent $4.5 billions in building Liberty ships. Shipyards worked seven days a week, twenty-four hours a day. During the years 1939-1945 the United States built a total of 5,768 merchant vessels, totaling 56,300,000 dead-weight tons. During the single year 1943, 1,949 vessels of 19,210,000 dead-weight tons were built. The costs of the program were great. The United States spent during the second World War a total of about $13 billions in building merchant vessels.

The War Shipping Administration was created in February, 1942, and requisitioned and operated all this country's merchant vessels, allocating cargo space on a priority basis. The shipping of the United States, the United Kingdom, and other United Nations was placed in a shipping pool. Most of the allied tonnage was allocated by the United States and the United Kingdom through the Combined Shipping Adjustment Board, consisting of representatives from these two countries. After the defeat of Germany the Combined Board was succeeded by the United Maritime Authority which was broadened to include sixteen other countries. This new body was dissolved shortly after the defeat of Japan, although a contributory pool was maintained to meet the needs for relief and reconstruction which were then urgent.

When the war was over in 1945 the United States possessed approximately 5,529 ocean-going vessels aggregating 56,798,000 dead-weight tons. Of these ships, about 1,065 were tankers. World shipping at the end of the war totalled 10,175 vessels of 91,664,000 dead-weight tons, which compared with 9,199 vessels of 71,845,000 dead-weight tons in 1939.

Immediately after the war the need for ships continued great, but as European countries reconstituted their merchant shipping and as new postwar ships were completed, many of the war-built ships were not needed. Passenger ships remained scarce, and the surplus was confined largely to the slower freighters.

The United States Government sold a large number of its surplus ships to foreign countries, and to private United States shipping companies in accordance with the Merchant Ship Sales Act of 1946. American shipping interests, fearing foreign competition, opposed sales of ships to foreign countries and objected to extension of the authority to sell ships to foreign buyers as urged by the Administration in connection with the European Recovery Program. This authority expired March 1, 1948. Foreign buyers had then purchased about 1,100 vessels. American buyers had purchased 847 vessels when the authority to sell to American buyers expired January 15, 1951.

Ships owned by the United States Government were excessive, and in order to keep them available to meet another emergency, a large number were stored in the reserve fleet, "in mothballs" as the preserving process was called. Storing ships for a future emergency was an experiment. The results, however, with respect to both merchant and naval vessels were satisfactory. At the beginning of the Korean war in June, 1950, about 2,300 merchant vessels of about 15,000,000 dead-weight tons were in the reserve fleet laid up under the preservation process. As a result of the need for ships, a large number of ships were removed from the reserve fleet and readied for service in periods ranging from about 10 days upward. The ships were found to be in good condition. By the middle of 1951 about 600 ships from the reserve fleet had been restored to service.

In January, 1951, the United States seagoing merchant fleet consisted of 3,401 vessels of 36,448,000 dead-weight tons, of which 2,005 vessels were in the reserve fleet.[3] At that time

[3] Of the 5,529 ships under the United States flag at the end of the war in 1945, many had been turned over to the Navy, transferred by their American owners to a foreign flag (particularly that of Panama), sold privately, or lost, so that the January, 1951, figure plus sales to foreigners does not equal the 1945 figure.

approximately 46 per cent of American water-borne foreign trade was carried in American flag vessels. This figure compares with about 27 per cent before the war, and was due in part to legislation requiring the utilization of American ships for certain shipments. As the international situation darkened in 1950 and thereafter, the need for ships again came to the fore. The United States, however, found itself in a reasonably satisfactory position in view of its large reserve fleet, although shipbuilding facilities had been allowed to deteriorate and were unprepared for rapid expansion.

History of United States Government Aid to Shipping.—Toward the end of the nineteenth century the United States began to be concerned over the great decline in the country's shipping that had taken place since the Civil War, and the very small number of American flag vessels then on the seas. During the Spanish American War in 1898, when Great Britain and other maritime countries took the position that the war was an American affair, the United States became acutely aware of its lack of ships. As a result of the war and the acquisition of the Philippines, international obligations of the United States were increased. The need for a larger number of both naval and merchant vessels was generally recognized. During the Boer War (1899-1902), when practically all British trans-atlantic shipping was diverted to South Africa, the United States felt the need for its own ships. The lack of ships was again emphasized in 1908 when the Navy, on a cruise around the world, had to be serviced by a fleet of foreign tenders.

Congressional debates over the problem went on for several years, and the merits of mail and other subsidies and of lower duties for goods carried in American ships were argued at length. The subject was complicated by the general fear of monopolies and trusts, whose abuses were then subject to public discussion, and by recognition of the need to improve conditions for seamen as well as to provide greater protection for life at sea. There was no desire to aid shipping in a way which would contribute to shipping monopolies. Furthermore, laws which were needed to improve conditions for seamen and to

increase safety at sea would add to the cost of American shipping, and tend to reduce rather than increase the size of the country's merchant marine.

After investigations and many bills introduced into Congress, the principal legislation which resulted was the Panama Canal Act of 1912, the Seaman's Act of 1915, and the Shipping Act of 1916. These acts dealt with the welfare of seamen, abolishing arrest and imprisonment for desertion and regulating conditions of work, with requirements to increase safety at sea, and with measures designed to aid the establishment of a United States merchant marine. The latter two acts reflected problems arising out of the first World War, which had begun in 1914. The Act of 1916 established the Shipping Board and gave it power to construct, acquire, and operate vessels. This Act, in addition, arranged for the regulation of shipping analogous to that of the railroads by the Interstate Commerce Commission. Shipping companies were permitted by the Act to participate in agreements or conferences, subject to approval of the Shipping Board, and were exempt from certain features of the anti-trust legislation when the agreement had been so approved. Certain monopolistic practices, however, were banned.

At the time of these acts it had become clear that American shipping could not by itself compete successfully with foreign shipping and would not revive without substantial government assistance. Government aid to shipping, however, was not new in the United States. One of the first acts of Congress in 1789 provided for government assistance to shipbuilding. The Navigation Act of 1817 closed all coastwise shipping to foreign vessels, thereby providing a protected field for American ships. This provision is still in force. These restrictions regarding coastwise shipping, and which include all interior shipping as well, have been extended to include trade with American outlying possessions. Ships in this trade must be built in American shipyards and owned by Americans. Tariff legislation in 1890 and 1894 endeavored to aid shipbuilding by placing shipbuilding materials on the free list, but little benefit was derived from this legislation.

Aid to shipping through the granting of mail contracts was undertaken during the years 1845-49, 1864-75, and later. In 1891 a subsidy act, the Ocean Mail Act, was enacted which provided for mail contracts with payments related to the speed of vessels. This Act was in force until 1923, but did not succeed in creating a strong merchant marine.

The Act of 1916, amended in 1918, enacted under the urgency of war needs, approached the problem directly, and provided for outright government construction of vessels, as noted above. As a result of the large number of ships built during the first and second World Wars and later made available to shipping companies at low figures, a substantial subsidy was in effect granted to shipping. The subsidy to operators that was involved in the acquisition of these low-priced ships, however, did not last indefinitely. As the ships became obsolete and replacements were needed the effects of the aid disappeared.

The Merchant Marine Act of 1920 sought, among other things, to provide continuing aid for American shipping. It established a loan fund to aid construction of ships, and granted certain tax exemption from earnings set aside for new construction. It also provided that in so far as practicable mails should be carried on American vessels, the payments to be just and reasonable. The Act, however, did not succeed in maintaining this country's shipping in a strong condition.

In 1928 another measure was enacted which established a mail contract system, according to which subsidies were given United States vessels on the basis of their size and speed. The 1928 Act also provided construction loans at low rates of interest. About 30 good combination vessels were built under this act, but the country's total shipping picture continued to deteriorate, partly because of the depression and the decline in foreign trade.

The Merchant Marine Act of 1936, still largely in force, was designed to rehabilitate America's declining merchant marine. According to the "declaration of policy of the act":

> It is necessary for the national defense and development of its foreign and domestic commerce that the United States shall have a merchant

marine (*a*) sufficient to carry its domestic water-borne commerce and a substantial portion of the water-borne export and import foreign commerce of the United States and to provide shipping service on all routes essential for maintaining the flow of such domestic and foreign water-borne commerce at all times, (*b*) capable of serving as a naval and military auxiliary in time of war or national emergency, (*c*) owned and operated under the United States flag by citizens of the United States in so far as may be practicable, and (*d*) composed of the best-equipped, safest, and most suitable types of vessels, constructed in the United States, and manned with a trained and efficient citizen personnel. It is hereby declared to be the policy of the United States to foster the development and encourage the maintenance of such a merchant marine.

To realize these objectives, the Act provides subsidies both for the construction and the operation of merchant vessels. According to the Act, the government, after approving the building of a ship, will pay the difference between the cost of constructing the vessel in an American and in a foreign shipyard, up to a certain percentage of the total cost. The government may lend most of the remaining cost of building the ship. The prospective ship owner must make a down payment of at least 25 per cent of the cost, and is allowed up to 20 years to pay the balance. The interest charge is 3 per cent. The government, also under this Act, subsidizes the operation of ships, paying ship owners the difference in cost between operating American ships and foreign ships under similar conditions. The Act provides that vessels receiving such financial aid are to be automatically available for national defense. The Act repealed both the loan and the mail contract provisions of the Acts of 1920 and 1928, under which high rates were paid for carrying very small amounts of mail. Mail is now paid for at regular poundage rates. The Act also provides for a system of direct grants of money based on operating cost differentials, schedules, etc.

An independent government agency, the United States Maritime Commission, was created by the Act and given broad powers. The Maritime Commission, consisting of five members, took over the functions of the United States Shipping Board and Merchant Fleet Corporation, which were dissolved.[4]

In 1950 the Maritime Commission was converted into the Federal Maritime Board, and the Federal Maritime Administration, by an Act of Congress which provided for reorganization of government agencies. The Federal Maritime Board and the Federal Maritime Administration were at that time both placed under the Department of Commerce to carry on the functions of the former Maritime Commission, although the Federal Maritime Board retained some of its independence, particularly with reference to subsidy awards. The new arrangement made possible the coordination of shipping policies more closely with other government policies. The former independent Commission had been considered as representing special interests more than the public interest.

In the spring of 1951 the Secretary of Commerce announced establishment of a National Shipping Authority in the Maritime Administration in order to provide for the most effective use of the American Merchant Marine during the emergency and rearmament period following the invasion of Korea. The functions of the National Shipping Authority have to do with the purchase, charter requisition, use and allocation of ocean-going vessels as well as the coordination of American shipping with that of other countries.

In order to aid American shipping, Congress has inserted in various laws a requirement that certain cargoes be carried wholly or partly in United States flag vessels. In 1934 in

[4] The Maritime Commission decided against the construction by America of large super-liners, such as were featured by European lines. According to the Commission, "the American contribution to North Atlantic travel should be fireproof, vibrationless, attractive, and economical vessels of reasonable size and speed, distinguished by the utmost in safety and comfort, suitable for business or pleasure travel, available for national defense, and manned by competent, resourceful, and disciplined personnel." (Economic Survey of the American Merchant Marine, United States Maritime Commission, 1937, pp. 22-23.) The first vessel contracted for by the Commission, the "America," was a medium-sized passenger liner to replace the obsolete "Leviathan." The ship was very useful during the war. After the war the "United States," a super-liner of 51,500 tons, 990 feet long, was built for the North Atlantic service and scheduled to enter this service in the spring of 1952. The high cost, over $70 million, was due partly to features which make the vessel adaptable to war purposes.

Public Resolution 17 (73rd Congress), Congress declared "it is the sense of the Congress" that American ships should, in so far as feasible, be used exclusively to carry cargoes financed by the government. As a result of the Economic Cooperation Act of 1948 and other legislation, shipments for the use of the army or navy and 50 per cent of good purchased out of United States Government loans or from the chief grants to foreign countries, must move in United States flag vessels. In view of the large amount of government aid extended to foreign countries during recent years, these cargo preference requirements have been responsible for a large amount of the cargoes carried in United States vessels. They have been of material aid to American shipping, although not without certain undesirable consequences noted below.

Economic Aspects of United States Shipping Policy.—In approaching the problem of American shipping policy two facts stand out clearly. First, as a result of the high United States costs of building and operating ships the United States is unable to compete successfully in these fields with other maritime nations unless special aid of some kind is given. Second, the United States for defense reasons needs a large merchant fleet, together with extensive facilities to build ships which can be quickly expanded to meet the needs of war. These facts are now generally accepted and no longer the subject of much debate.

In the light of this situation a number of significant questions arise, such as, what are the most effective and economically desirable types of subsidy? How large a merchant fleet is needed for defense? How much reliance should be placed upon ships of allies? To what extent should the government itself own and operate merchant vessels? How much current shipbuilding is necessary to maintain skills and facilities for emergency expansion? How large a merchant fleet should be held in reserve and how large a fleet in active service? How much of the world's foreign trade should the United States attempt to carry and how much should be carried by other maritime countries?

High shipping costs in the United States are the result, among other things, of high labor costs and the large amount of labor going into the building and operation of a ship. Assembly line methods are not applicable to shipbuilding. The construction contract (before the war) for the "America" was $15,-700,000, whereas the Maritime Commission estimated that a comparable vessel built in the Netherlands would then cost only $10,500,000. Operating costs of United States vessels are similarly high to a large extent because of high wages. The following figures show a comparison of wages of seamen in different countries:

TABLE 16

MONTHLY WAGES OF ABLE SEAMEN

Country	Basic Wage 1938	Basic Wage 1947	Estimated Total Pay 1947
United States	$73	$192	$290
Great Britain	48	96	103
Denmark	42	85	90
France	35	79	92
Netherlands	50	74	80
Norway	42	101	108
Sweden	44	86	115
Germany	50		
Italy	27		
Japan	14		

(Source: Report of President's Advisory Committee on the Merchant Marine, Washington, D. C., Nov., 1947.)

Practically all operating costs such as those of management, subsistence of crew, repairs, and maintenance are higher for American companies than for foreign companies. A large American company operating tankers estimated that the costs in 1947 of operating a T-2 tanker for one year (350 days) were $582,700 for the United States, $433,500 for Great Britain, and $431,500 for Norway. A portion of the higher United States costs is the result of United States government

regulations requiring certain high standards. In addition to extending aid to American ships the government, in exercising its responsibility for safety at sea and for the treatment of seamen, has necessarily increased operating costs and interfered with the competitive position of American shipping companies. Few persons, however, would argue for lowering of these standards.

Aid to shipping at the present time takes the form, as noted above, of construction subsidies, operating subsidies, and cargo preferences. The government will thus pay a large portion of the cost of building a vessel. Operating subsidies are paid to ships on regular foreign trade routes and are related to operating cost differentials between United States and foreign vessels. The payments are not designed to guarantee a profit to the operator, but are intended to equal the difference between United States operating costs and competing foreign costs.

In formulating a shipping aid program it would seem that inasmuch as government aid is to be justified on grounds of defense, the aid should be geared to authoritative and impartial estimates of the amount and types of merchant shipping needed for defense. This approach has not been utilized extensively in the past by the United States. A problem arises in the fact that the tonnage needed in time of war is far greater than that required for the conduct of peacetime trade, especially if the United States is not to seek more than its fair share of the world's carrying trade, recognizing that shipping is a principal means of livelihood for certain other countries.

A reserve of merchant vessels provides part of the answer to the difference between wartime and peacetime needs. In addition to ships in existence, however, shipbuilding facilities are needed so that shipping can expand and according to types of vessels as war requirements determine. An adequate and healthy shipbuilding industry is considered important to defense. A ship subsidy program should thus assure not only a large and ready supply of vessels, but adequate shipbuilding facilities to take care of replacement needs and provide additional ships in time of war. It has been suggested that ship-

building should be subsidized directly rather than as a by-product of ship operations.[5]

The cargo preference system, while of substantial benefit to shipping, does not assure a volume of shipping which coincides closely with estimated defense needs. The amount of aid derived from cargo preferences fluctuates with the extent of government-aid programs and with other foreign economic operations of the government. Such a system does not relate the size of the country's shipping which results from the aid to defense requirements. It also weakens the advantages derived from competition for cargoes, reducing pressure on operators for efficiency and economy in operations and better services. It results in higher transportation costs measured in terms of freight rate differentials between United States and foreign ships.

More serious than these drawbacks, however, is the discriminatory nature of cargo preferences. Such preferences are harmful to the trade of other maritime nations and are inconsistent with United States belief in the advantages of freedom of opportunity, and with this country's efforts toward a liberal multilateral world trading system, free from burdensome restrictions. Other countries resent these American discriminatory measures, and have expressed their views to this government. They are aware of the inconsistency between American shipping measures and this country's foreign economic policies as sought in other fields.

The exceptionally large portion of United States trade carried by United States vessels, about 46 per cent in 1950, is due in large measure to cargo preferences granted American flag vessels. Marshall plan dollars were paid to American companies to carry cargoes at high rates which European ships were able and eager to carry at lower rates and which would have earned needed dollars for European countries.

Ocean shipping is becoming increasingly a matter of interest to governments, as countries more and more desire to have merchant marines of their own, or as they endeavor to counter

[5] Gordon Gray, *Report to the President on Foreign Economic Policies* (Nov., 1950).

the effects of foreign subsidies. Shipping is thus being subjected to an increasing number of restrictions and discriminations designed to favor national ships. Since the United States has itself engaged extensively in discriminatory practices, it is in a weak position to object. American shipping interests have long been active and effective proponents of discriminatory measures, when practiced by the United States, and are reluctant to see the system altered. If the United States were suddenly to remove its cargo preferences, American ships might lack sufficient cargoes in view of the extensive application by other governments of preferences and discriminations directly or indirectly. A change in the system therefore requires the substitution of other types of aid, or reciprocal elimination of such practices. Outright subsidies appear to be the most effective and generally suitable type of assistance to shipping.

A solution to the problem is being sought by the United States along international lines. A shipping conference was convened in Geneva in February, 1948, by the Economic and Social Council of the United Nations, following conversations among interested nations. This conference prepared plans for an Intergovernmental Maritime Consultative Organization. A main objective of the proposed organization is to facilitate the elimination of governmental discriminatory measures, and also unfair and restrictive practices engaged in by shipping companies. It is designed to be one of the specialized agencies of the United Nations. Through this organization, which has not yet come into existence, the United States and other countries may be able to negotiate reciprocal agreements to relax discriminations which are harmful to shipping and to the expansion of trade generally.

Chapter 38

INTERNATIONAL ECONOMIC COOPERATION —UNITED NATIONS ECONOMIC ACTIVITIES

Development of Intergovernmental Cooperation.—Events of the past few decades have illustrated the difficulties that arise from lack of cooperation among nations in economic and political affairs. These difficulties have emphasized the basic interdependence of nations and regions, and have strengthened demands that nations find ways of relating their economic systems so that they will function to better advantage than they have in the past.

The physical potentialities of the world's productive facilities are very great on the basis of present technology and manpower. If nations can devise means for utilizing more fully and efficiently their resources, labor supply, and technological knowledge, the world's production can be greatly expanded. Among the hindrances to fuller production have been those resulting from the nationalistic organization of the world, and from the large number of independent and uncoordinated economies, with their own currencies, fiscal systems, tariff barriers and separate policies. Rivalries, suspicions and uncooperative measures in the political field, together with autarkic and isolationist measures in the economic field have combined to retard general advancement and an improvement in living standards. A major drain on living standards resulting from lack of governmental cooperation is, of course, the maintenance of armaments, made necessary largely by the aggressive policy of the Soviet Union.

Nations have been reluctant to integrate their economies and to take measures in the interests of a more adequately functioning economic order because such integration and measures

would increase their dependence on other countries, and especially would involve a surrender of certain authority. A surrender of authority, of sovereign rights as it is described, is not a new procedure, since every treaty or binding international agreement involves to a greater or less degree a surrender of the right to independent action. Nationalistic thinking has dominated a large number of statesmen and their publics. The loose cooperation which has thus far been undertaken is far from adequate, although during the past decade notable progress has been made. The common danger to the free nations during recent years has tended to bring them closer together, but they must eventually go much farther in uniting their economic and political systems if major goals are adequately to be achieved.

Nations have historically undertaken to resolve their problems with other nations by direct bilateral negotiations and resulting agreements. The idea of multilateral negotiations, wherein a large number of nations participate, and of multilateral agreements and machinery, is essentially of recent origin, except with respect to military collaboration and arrangements regarding peace. Joint action by a group of nations has not been the customary procedure in international affairs. The growth of the multilateral approach has been a result of the expansion of the common interest to include a larger and larger number of countries, rather than merely two countries which negotiated over a problem of concern only to themselves.

An early multilateral organization was the Hanseatic League, formed in the early fourteenth century.[1] This League was made up principally of independent German cities, nearly 100 members in all, and was concerned primarily with trade matters and protection of ships from marauding pirates. It had its own assembly, courts, treasury and army. It waged war and controlled nearly all the trade on the Baltic and North Seas. Such joint undertakings by a large number of independent or semi-independent political units have not been common until after the second World War. The bilateral approach has been and still is the customary method whereby nations arrange matters having to do with their relations with each other.

[1] See Chapter 2.

The United States first participated in a multilateral arrangement in 1865. At that time it joined a group of eleven shipping nations which entered into an agreement with the Sultan of Morocco regarding the construction and maintenance of a lighthouse at Cape Spartel on the shore of Africa at the Atlantic entrance to the Straits of Gibraltar. The United States still contributes about $1,000 a year to this joint undertaking. The United States joined the General Postal Union in 1847, and the International Bureau of Weights and Measures shortly thereafter. In 1882 the United States subscribed to the Geneva Convention of 1864 which established the Red Cross. The formation of the Pan American Union in 1890 and the prominent role played by the United States in this organization and inter-American affairs generally have been discussed in Chapter 35. By 1900 the United States was a party to about five other multilateral conventions. After that time, however, United States participation in international machinery was extended only slowly until after the second World War.

The United States did not join the League of Nations which came into existence after the first World War. The absence of this country from the League was a severe blow to international cooperation at that time. During and after the second World War, however, the United States played an active part in sponsoring the formation of a large number of international bodies, centering around the United Nations which represented to a large extent the results of United States efforts.

League of Nations.—Efforts toward international economic cooperation go back for many years as noted above, but the first World War gave special impetus to concerted moves in this direction. Among the international organizations which came into being after the first World War, and whose objectives were, among other things, broad cooperation in dealing with economic as well as political questions, was the League of Nations. The League came into existence in 1920, largely on the initiative of the United States, and was participated in by sixty-four nations. Its membership included practically all the countries of the world except the United States.

The economic activities of the League and its committees centered in the Economic and Financial Organization. Under League auspices, as arranged by this body, a number of committees were established and conferences held to consider a variety of economic and social questions. Some of the subjects dealt with by the League were control of opium traffic, access to raw materials, health and sanitation, statistical coordination, simplification of customs formalities, and a large number of other subjects. Special studies were undertaken and valuable reports published. The statistical compilations of the Economic and Intelligence Section of the Secretariat provided precise and accessible data which had hitherto been largely not available on a comparable basis. The economic work of the League was extensive and gained the confidence and respect of economic students everywhere. The work, nevertheless, was primarily of a research and advisory nature so that the results in the form of concrete actions taken by governments were limited.

An important accomplishment of the League was its rehabilitation of Austria and also of Hungary after the first World War. When Austria was separated from the old Austro-Hungarian Empire and proclaimed a republic, the country was in a critical condition. Inflation was rampant, the food supply inadequate, and the country practically bankrupt. It had been divested of much of its vital territory by the peace settlement.

The matter of Austria's critical status was taken up at the Brussels conference in 1920. Credits were granted the country by the different European nations and by the United States, so that conditions were relieved, but only temporarily. The situation in Austria continued grave, and in 1922 Austria appealed to the Allied nations for further aid. The matter was referred to the League of Nations, which thereupon undertook the reconstruction of Austria.

Under League auspices the finances were reorganized, the currency stabilized, a national bank established out of the Austrian section of the former Austro-Hungarian Bank, and other economic measures adopted. An international loan was negotiated, different portions of the loan being guaranteed by the following countries: Great Britain, France, Czechoslovakia,

Italy, Belgium, Sweden, Holland, and Denmark, the first four countries being responsible for the largest portions. As a result of League of Nations aid Austria was enabled to overcome the most serious of its difficulties, although the country continued to be faced with a number of important problems, political and economic.

The League of Nations subsequently undertook in similar fashion the reconstruction of Hungary, which was also carried through with notable success. The same methods which were utilized so successfully in Austria and Hungary were applied in varying degrees in Greece, Bulgaria, Estonia, the Free City of Danzig, Albania, and the Saar Territory.

The work of the League during most of its life was carried on under difficult circumstances. The absence of the United States from the League was a serious handicap to its prestige and work. The League operated much of the time in the midst of international tension and finally war. The work, however, was not allowed to lapse with the outbreak of war in September, 1939, and much of it was continued from League offices in Princeton, New Jersey.

The International Labor Organization (ILO) was an autonomous organ of the League of Nations created in 1920 at the same time as the League. The United States was a member of the International Labor Organization. This organization sought to improve conditions for laborers everywhere and was concerned with such matters as the development of standards for labor legislation. During the war the activities of the International Labor Office were carried on from Canada. The organization is still in existence and is one of the specialized agencies of the United Nations.

International Economic Conferences.—During the nineteen twenties and thirties several attempts at economic collaboration were made through the medium of international conferences. The results, however, were largely disappointing.

In 1920 when currencies and exchange rates were extremely disturbed throughout all Europe, a financial conference was held in Brussels. Financial conditions in Europe, as a result of the

first World War, were chaotic. Inflation was rampant; prices were rising rapidly; exchange rates were depreciated and fluctuating erratically; government debts were growing; and national antagonisms and suspicions were keen. The conference met in the midst of these conditions to do what it could to help reconstruct financial systems. It adopted several resolutions urging the removal of impediments to trade, abandonment of the limitations upon exchange operations, and the reestablishment of the gold standard. These declarations had a wholesome influence, but resulted in little concrete action.

Two years later, in 1922, another conference assembled in Genoa, Italy, to carry on the work begun in Brussels. The Genoa conference dealt especially with the question of currency stabilization, a most urgent problem at that time. It recommended that all European currencies be based upon the gold standard. It declared against financing budgetary deficits by paper money issues, which was still the procedure in several countries, and declared that currency stability was a first requirement for economic equilibrium. The vital questions of reparations and war debts, however, were ruled out, because feelings regarding them were considered too strong to permit of their impartial consideration.

The so-called Dawes Conference met in Paris early in 1924 for the purpose of reaching some working arrangement on the troublesome question of reparations. The amounts demanded of Germany by the Allies were far in excess of Germany's ability to pay. Attempts to collect from Germany, and German attempts to pay the sums demanded, were in part responsible for the extremely disturbed economic conditions prevailing throughout most of Europe. Inflation in Germany had reached the point where trade and the conduct of ordinary business had practically collapsed.

The Dawes Conference, called by the Reparation Commission of the allied powers, met at a critical time when some sort of a workable financial arrangement was imperative. The conference established what sums it thought Germany could reasonably be expected to pay during the next few years, purposely leaving the total amount of the reparation bill indefinite so

as to bring agreement. Plans were prepared regarding measures for the financial and economic reconstruction of Germany, including stabilization of the currency. The recommendations of the conference were promptly put into force with successful results. The conference marked a turning point in post-war European economic affairs, away from chaos toward an ordered, although still disturbed, economy. The record of accomplishment of many international conferences is not particularly significant, but such was not the case with the Dawes Reparation Conference, partly because of the urgent necessity of doing something. The reparation question is discussed in Chapter 39.

The first so-called World Economic Conference assembled in Geneva in 1927 under the sponsorship of the League of Nations. This conference, to which the United States sent delegates even though this country was not a member of the League, concerned itself particularly with the question of trade barriers. Nearly fifty nations were represented at the conference by some 200 delegates, consisting of leading business men, bankers, economists, and government officials. All over the world the tendency of nations had been to raise tariff and other barriers continually higher. Most of the newer nations, brought into existence since the war, were turning toward economic nationalism, and had aims of increasing their self-sufficiency by the shutting out of many foreign goods. The conference declared definitely against trade barriers, pointing out the interdependence of nations. It urged the immediate reduction, by successive stages, of the barriers which so gravely hampered trade. In spite of these declarations, the nations of the world, including the United States, continued on toward higher and higher tariffs and other forms of restriction.

The second World Economic Conference met in 1930, at a time when the world depression was getting under way. This conference accomplished very little of a constructive nature.

The Dawes Plan regarding reparations had involved only a temporary settlement, since this was all that could be accomplished at that time. By 1929, Germany, irking under the payments, was anxious to have the amounts scaled down and matters settled permanently. A second reparation conference

was accordingly held, in 1929, this time under the chairmanship of another American, Owen D. Young. As a result of this conference the amounts to be paid were substantially reduced. With the depression which followed almost immediately, came the 1931 moratorium on war debts and reparations, on the initiative of President Hoover, so that payments under the Young Plan were short-lived. After the expiration of the moratorium, few further payments were made. Another conference on reparations was held at Lausanne in 1932, and provided for a final payment by Germany, contingent upon a "satisfactory settlement" of the war debt question by the United States. No payments, however, were made under this arrangement.

As the world depression increased in severity, and as currency disorders spread following the departure of Great Britain from gold in September, 1931, renewed realization of the intimate economic and financial relationships among nations led to discussions regarding the holding of another world economic conference. Accordingly, the Monetary and Economic Conference convened in London in June, 1933 with high hopes, and with 66 nations participating.

It was generally expected that the conference would deal especially with the pressing question of currency and exchange stabilization. Commodity prices all over the world had been suffering drastic declines. Trade was stagnant, and unemployment widespread.

The United States was expected to help lead the way toward financial reconstruction and stabilization. The Roosevelt Administration in the United States, however, was at the beginning of its price-raising policy aimed to further recovery. This country's currency ideas, moreover, were not yet fully formulated. The policy of raising the domestic price level in the United States, and depreciating the gold value of the dollar, was of course inconsistent with stabilization of exchange rates between dollars and other currencies. The United States was, therefore, unable to cooperate in the program of internationai currency stabilization. When the conference was informed of the position of the United States, a great deal of ill-will was

directed toward this country, and the conference soon broke up having accomplished almost nothing.

The conference, however, took significant action with respect to silver. Under the sponsorship of American silver interests, a resolution, introduced by the United States delegation, was approved unanimously by the delegates of the sixty-six nations. It recommended that nations using, producing, or holding silver make an agreement with a view to mitigating the fluctuations in the price of the metal; that the nations refrain from further debasement of silver coinage; and that they substitute silver for low value paper currency. The agreement referred to was signed outside the conference by eight nations. It provided, among other things, that India limit its annual sales of silver, and that other nations withdraw from the market annually a certain amount of their mine production.

The silver agreement was regarded generally as looking toward stabilization of the price of silver, which meant prevention of the sharp declines which had been taking place. However, the United States silver policy became one of extensive buying of the metal for the purpose of raising its price. The effects upon China of the rise in the price of silver were profound, and forced China to abandon that country's historic silver standard as discussed in Chapter 26.

A number of international conferences were held during and after the second World War to prepare plans for the formation of several specialized international agencies. These included the United Nations Conference on Food and Agriculture held at Hot Springs, Virginia, in 1943, the United Nations Monetary and Financial Conference held at Bretton Woods in 1944, and the International Civil Aviation Conference held in Chicago in 1944. Out of these conferences came the United Nations Food and Agriculture Organization, the International Monetary Fund, the International Bank for Reconstruction and Development, and the International Civil Aviation Organization, specialized agencies affiliated with the United Nations.[2] Economic

[2] The Fund and Bank while affiliated with the United Nations are not subject to its authority.

conferences to consider Western Hemisphere problems are discussed in Chapter 35.

Monetary Cooperation.—The first significant cooperative currency arrangement in modern times was in 1865 when the so-called Latin Monetary Union was formed. This grew out of the currency difficulties following the fall in the value of gold after the California gold discoveries of 1849 and 1850. As a result of the cheapening of gold, or rise in the price of silver, Switzerland reduced the amount of silver in her subsidiary coins. These then began to be substituted in the neighboring countries, where Swiss coins were current, for the full weight coins of these other states, notably of France. In order to remedy the difficulties and to facilitate trade and financial dealings, a treaty was negotiated between France, Belgium, Switzerland, and Italy, the aim being to establish in these nations uniform coinage on a bimetallic basis.[3]

The agreement provided for the minting by the different nations of coins of similar weights and finenesses, involving the same ratio, 15½ to 1, between gold and silver. The size and general appearance of the coins were identical in all four of the countries, although their insignia differed. The coins of the four nations parties to the agreement were accepted in any of these countries, thus circulating across national boundaries.

Soon after the monetary union was launched, the price of silver began to decline in terms of gold. Large amounts of silver were then presented for coining into five-franc pieces at the mints of these countries. As a result, the countries were afraid that they might be forced onto the silver standard, and therefore by agreement limited the amount of silver which each could coin. The price of silver continued downward, and in 1878 the coinage of silver five-franc pieces was completely suspended. Although the Latin Monetary Union continued in nominal existence, the countries all shifted to the gold standard, and the agreement became a dead letter. The gold value of their currencies, however, continued similar, down to the first World War.

[3] Spain and Greece participated in the negotiations but never put the agreement into force.

The Scandinavian Monetary Union was formed between Denmark, Norway, and Sweden, and according to the treaties of 1873 and 1875 gold and silver coins of any of these three countries were lawful money in all of them. The currency system was the gold standard, and silver money was coined only on government account, its supply thus being limited. Silver coins were legal tender only up to certain amounts. The bank notes of the three Scandinavian central banks were also accepted at par in all three countries. The central banks held balances for one another and sold drafts against these balances, usually at par. In this manner the central banks kept exchange rates practically at par.

The Scandinavian Monetary Union continued successfully until during the first World War. When the currencies of Norway and Denmark became depreciated in Sweden and when gold exports by Norway and Denmark were interfered with, silver coins were sent to Sweden to establish balances there. Large quantities of the fiduciary silver coins thus appeared in Sweden. The traffic was stopped, and Norway and Denmark bought back their silver at considerable expense. In 1924, Sweden declared the money of Norway and Denmark no longer valid in Sweden.

In September, 1936, when France devalued the franc, the United States, Great Britain, and France announced that they had concluded an agreement, which became known as the Tripartite Currency Agreement, according to which these nations agreed to cooperate in the stabilization of their currencies. Other nations were invited to participate, and Switzerland, the Netherlands, and Belgium soon joined in the accord.[4]

[4] The announcement of the United States Treasury said in part:

"1. The Government of the United States, after consultation with the British Government and the French Government, joins with them in affirming a common desire to foster those conditions which safeguard peace and will best contribute to the restoration of order in international economic relations. . . .

"2. The Government of the United States must, of course, . . . take into full account the requirements of internal prosperity, . . . it welcomes this opportunity to reaffirm its purpose . . . to maintain the greatest possible equilibrium in the system of international exchange and to avoid to the utmost extent the creation of any disturbance of that system by American monetary action.

"3. . . . The United States Government, as also the British and French

Soon after this agreement, or declaration, was made public, the United States announced it had entered into an arrangement with Great Britain and France for the purchase and sale of gold through the stabilization funds of the respective countries, for the purpose of reducing the fluctuations between their currencies (October, 1936). Gold imports and exports into or from the United States were to be undertaken by the government, and private licenses to export gold were to be practically abolished. Gold was to be exported only to nations parties to the agreement.[5]

In June, 1937, France suffered severe losses of gold, with the result that France was forced to permit the franc to decline; on July 1 the previous legal limits to exchange fluctuations were removed. In the mind of the public in the different countries, the question was raised as to whether the Tripartite Currency Agreement was still in force. The matter was promptly settled by an exchange of communications on July 1, between the Treasuries of the three countries. Secretary Morgenthau addressed the following message to the French Minister of Finance, and a similar message was sent by Great Britain: " . . . I look forward to a continuation of close cooperation between our Treasuries under the Tripartite Declaration."

Governments, declares its intention to continue to use appropriate available resources so as to avoid as far as possible any disturbance of the basis of international exchange resulting from the proposed (French) readjustment.

"4. The Government of the United States . . . attaches the greatest importance to action being taken without delay to relax progressively the present system of quotas and exchange controls with a view to their abolition.

"5. The Government of the United States, in common with the Governments of France and Great Britain, desires and invites the cooperation of the other nations to realize the policy laid down in the present declaration. It trusts that no country will attempt to obtain an unreasonable competitive exchange advantage and thereby hamper the effort to restore more stable economic relations which it is the aim of the three Governments to promote." *Federal Reserve Bulletin,* October, 1936.

[5] The Secretary of the Treasury in his announcement said that the United States would "sell gold for immediate export to, or earmark for the account of, the exchange equalization of stabilization funds of those countries whose funds likewise are offering to sell gold to the United States, provided such offerings of gold are at such rates and upon such terms and conditions as the Secretary may deem most advantageous to the public interest."—*Federal Reserve Bulletin,* Aug., 1937.

After the outbreak of war in September, 1939, Secretary Morgenthau issued a statement to the effect that the agreement was still in force. With the occupation of France and the other countries by Germany, however, the agreement became a dead letter. The agreement, although short-lived, was a move toward joint action in the monetary and exchange field. The agreement contained a statement that the United States "attaches the greatest importance" to the relaxation of quotas and exchange controls. The agreement was a declaration of purpose and intent rather than a binding contract, and was voidable at any time; which facts made it more acceptable to the American public.

In 1934 the United States established a stabilization fund of $2 billion in gold, the money representing part of the profits realized from the increase in the monetary value of this country's gold reserve as a result of the devaluation of the dollar in that year. This fund, later reduced in amount when the United States joined the International Monetary Fund, and when most of it was used to provide part of this country's subscription to the International Monetary Fund, has been used to help stabilize exchange rates between the dollar and other currencies. It is operated by the Treasury Department which has entered into a number of stabilization agreements, particularly with Latin American countries, whereby the United States undertakes under certain conditions, to purchase the currency of the foreign country up to a specified amount. These agreements have now lapsed with the exception of that with Mexico, which is still in force. The stabilization fund is also used to carry on government purchases and sales of gold.

The most significant developments in the field of international monetary and exchange cooperation are the sterling area, the International Monetary Fund and the European Payments Union. These have been discussed in detail in other chapters, and to avoid repetition will not be considered here.

It has been suggested at various times that countries adopt a single international currency unit, so as to avoid the problems centering around exchange rates and the transfer of funds. While there is much merit to these proposals, an international

currency unit is usually considered not feasible until countries are prepared to merge to a large extent their fiscal systems, and to establish an international monetary authority in the true sense of the word authority. The difficulties that result from a large number of independent currency systems are great, and it is to be hoped that eventually currencies can be united in the interests of economic progress. The International Monetary Fund represents a major effort toward monetary cooperation, yet the authority of the Fund is limited. Further cooperation in the monetary field is needed but must go hand in hand with further cooperation in the political and economic fields generally.

Benelux.—Under the name Benelux the countries of Belgium, the Netherlands, and Luxembourg are in the process of merging their economies into what it is hoped will eventually be complete economic union. The plan is to abolish all trade barriers between these countries, to establish a common currency and otherwise to bring about a full merger of their economies.

Belgium and Luxembourg have had full economic union since 1923. The Belgian franc and the Luxembourg franc are freely convertible and circulate interchangeably at par, so that the problem of completing the plans for Benelux have had to do primarily with the uniting of the Belgian and Dutch economies.

Plans for economic union by the three countries were developed during the second World War by their governments-in-exile in London. The decision was taken there in 1944 to establish an economic union once the war was over.

The implementation of this decision and the working out of the detailed arrangements have required extensive negotiations and have taken longer than was originally anticipated. The difficulties have been economic, political and social. The removal of protection is never an easy task.

A tariff union was put into force January 1, 1948, abolishing all duties between the three countries and establishing a uniform tariff against other countries. Dependent overseas territories

are not included in the union. The freeing of trade by this move was, however, not very great since quantitative restrictions and exchange controls continued in force. Since then, however, the bulk of the trade has been freed from these restrictions.

The greatest difficulties to economic union have perhaps been in the monetary and fiscal fields. Belgium and the Netherlands have separate currencies and separate monetary reserves. Belgium, which suffered from war destruction less than the Netherlands, followed a policy of the early removal of controls, allowing wages and prices to rise and the importation of large amounts of consumers goods. The Netherlands on the other hand has followed a policy of controls and rationing. The Netherlands has experienced continuing deficits in its international payments, and has received extensive credits from Belgium. The negotiations on means to bring the monetary conditions in the two countries into closer similarity have brought out differences of opinion with respect to the appropriate monetary policy which should be followed by the economic union.

In the international field the three governments are more and more acting jointly in negotiations and thus enjoy greater bargaining power. In the multilateral tariff negotiations at Geneva, Annecy and Torquay the Benelux countries negotiated as a unit.

While complete economic union among the Benelux countries has been postponed a number of times, and while developments have been slower than anticipated so that pessimistic forecasts of the outcome have appeared—an offset to some of the excessively optimistic forecasts—nevertheless, significant progress has been and is being made.

Similar plans for a customs union and other measures of economic integration have been under consideration in the Scandinavian countries, and also by France and Italy under the name Francital. A treaty looking to a customs union and later an economic union was signed by France and Italy in 1949. Plans, however, are still considerably less advanced than are those in the case of Benelux.

Bank for International Settlements.—The report of the Young Committee on Reparations in 1929, discussed in the next chapter, recognizing the need for central bank cooperation, proposed the establishment of the Bank for International Settlements (BIS). The Bank, a joint undertaking sponsored by the leading nations, was organized in May, 1930, with headquarters in Basle, Switzerland. The stock of the Bank was subscribed for by the central banks of twenty-six leading nations. The United States Government did not desire the Federal Reserve Banks to purchase stock, a reflection of the isolationist sentiment in the United States at that time, so the amount allotted to this country was bought by private American banks. The Bank of Japan also did not participate in stock ownership because, it was said, of the distance from Tokio to Basle. The stock allotted to Japan was accordingly held by a group of Japanese bankers. Each of the seven founder countries, Belgium, France, Germany, Great Britain, Italy, Japan, and the United States, were allotted 8 per cent of the 200 shares of stock.[6]

The Board of Directors consists of twenty-five members made up as follows: (*a*) the governors of the five central banks of the countries mentioned above, excluding the United States and Japan, together with a Japanese and an American selected by these five governors; (*b*) one business man from each of the above seven countries; (*c*) nine persons representing banks of participating countries. Group (*a*) above selects group (*b*), and they together select group (*c*). The first two presidents of the Bank were Americans. The Bank is not allowed to issue circulating notes, and its operations in any country are subject to approval of the central bank of that country.

Much of the work of the Bank during its early existence was expected to be the receipt and disbursement of reparations. This was the case, but in 1931 reparation payments were suspended. Furthermore, the Bank had scarcely begun operations when depression seized the world. Although the activities of the

[6] Some of the stock was sold by the central banks of France and Belgium to the public, although these banks retained their voting rights.

Bank were not as extensive as was expected, and while the Bank did not develop along the lines anticipated, due to the cessation of reparations, international economic disturbances and finally war, the Bank served a useful purpose. The periodic meetings of the governors of the different central banks, as directors of the BIS, provided a means of getting these men together regularly and without publicity, resulting in informal cooperation which was greatly needed. The Bank eliminated some of the gold movements by offsetting debits and credits. It made advances to banks in various parts of the world for the purpose of stabilizing conditions and preventing financial troubles. It loaned considerable sums to the German Reichsbank in 1930 and 1931. It also aided Austria in 1931. The statistical services of the Bank were also valuable. Most of the Bank's day-to-day work had to do with devising principles and techniques for central bank cooperation.

Germany played a prominent role in the Bank's affairs, and after the outbreak of war in 1939, formal control of the Bank passed to Germany as a result of German acquisition of the interests of countries taken over or occupied by Germany. The Bank in the fall of 1939 decided:

1. To suspend all meetings of the Board of Directors.
2. To announce the intention to refrain from operations which were not "above reproach both from the point of view of belligerents and neutrals."
3. To refrain from any act implying recognition of political or territorial changes not unanimously approved.
4. To subject every operation to searching scrutiny, especially from the standpoint of the rules of conduct which the Bank had laid down.

The Bank came under criticism in Allied countries in view of its relations with Germany and its transfer of gold which had been looted by Germany from occupied countries. The Bank disclaimed knowledge as to the source of the gold, and also said "It was not legally open to the Bank to refuse payments made in accordance with the contracts entered into under

the Hague Agreements." [7] When the war was over the Bank made an inquiry to trace the origin of all gold bars received during hostilities. In 1948 an agreement was concluded between the Bank and the governments in question wherein the amount of looted gold received by the Bank was fixed at 3,740 kilogrammes.

During the war bankers from the Allied countries and from Germany frequently met at the Bank's headquarters in neutral Basle and compared notes. The activities of the Bank during this period were not extensive.

At the Bretton Woods Conference in 1944, which drew up plans for the International Monetary Fund and the Bank for Reconstruction and Development, a resolution was adopted that the Bank for International Settlements be liquidated. This recommendation, however, was not carried out. The European countries valued the Bank's functions. The Bank provided a meeting place for officials of Europe's central banks where they could periodically discuss mutual problems. The Bank's statistical services and its Annual Reports, which contained a critical review of economic and financial conditions, were also valued.

Since the war the Bank has confined its business activities to short-term operations (only in exceptional cases over a year). Technical cooperation was arranged between the Bank and the International Monetary Fund and the International Bank for Reconstruction and Development.

In 1948 the Bank made an arrangement to serve as agent for the execution of the Agreement for Intra-European Payments and Compensation. This function was later replaced by a similar function for the European Payments Union.[8]

The United Nations.—During the second World War it came to be widely assumed in all countries that when the war was over a new and effective international organization would be formed to replace the League of Nations. The League,

[7] Bank for International Settlements, *Twentieth Annual Report* (Basle, Switzerland, 1950).

[8] See Chapter 24. The Bank's *Twentieth Annual Report* for the year ending March 31, 1950, contains a review of the Bank's activities during its twenty years of life, 1930-50.

which had suffered severely from the lack of United States membership and support, was generally considered a failure in that it had not prevented aggression and war. Regardless of the reasons for the League's failure to prevent war, it was clear that the League did not enjoy the public's confidence to the extent required, and was to be replaced.

Early in the war, studies were undertaken by the United States Department of State regarding the nature and scope of a possible new central international organization, and of specialized agencies which would also be needed. Sentiment in the United States had shifted and was then strongly in favor of this country's participation in an international organization. Detailed plans were prepared and discussions held with other governments. By early 1945 agreement had been reached among the leading nations regarding the general nature, responsibilities and authority of the proposed new organization.

The United Nations Conference on International Organization, with fifty nations participating, met in San Francisco in April, 1945, and by June had completed the drafting of the charter for the United Nations. The charter was promptly approved by the necessary number of countries, including the United States, and the United Nations came into existence in October, 1945. The League of Nations ceased to exist in April, 1946, its facilities, including the buildings at the League's headquarters in Geneva, being transferred to the United Nations. Much of the work of the League was taken over and continued by the United Nations. The United Nations in July, 1951, had sixty members.[9]

The United Nations conducts its activities through five main organs and a Secretariat. The five main organs are the General Assembly, the Security Council, the Economic and Social Council, the Trusteeship Council, and the International Court of Justice. The Secretariat and other personnel who carry on

[9] There were at that time twenty nonmembers as follows: Albania, Austria, Bulgaria, Cambodia, Ceylon, Finland, Hungary, Ireland, Italy, Japan, Jordan, Korea, Laos, Monaco, Nepal, Rumania, San Marino, Switzerland, Vatican City, and Vietnam. The only country among these which did not belong to some of the international agencies was Nepal.

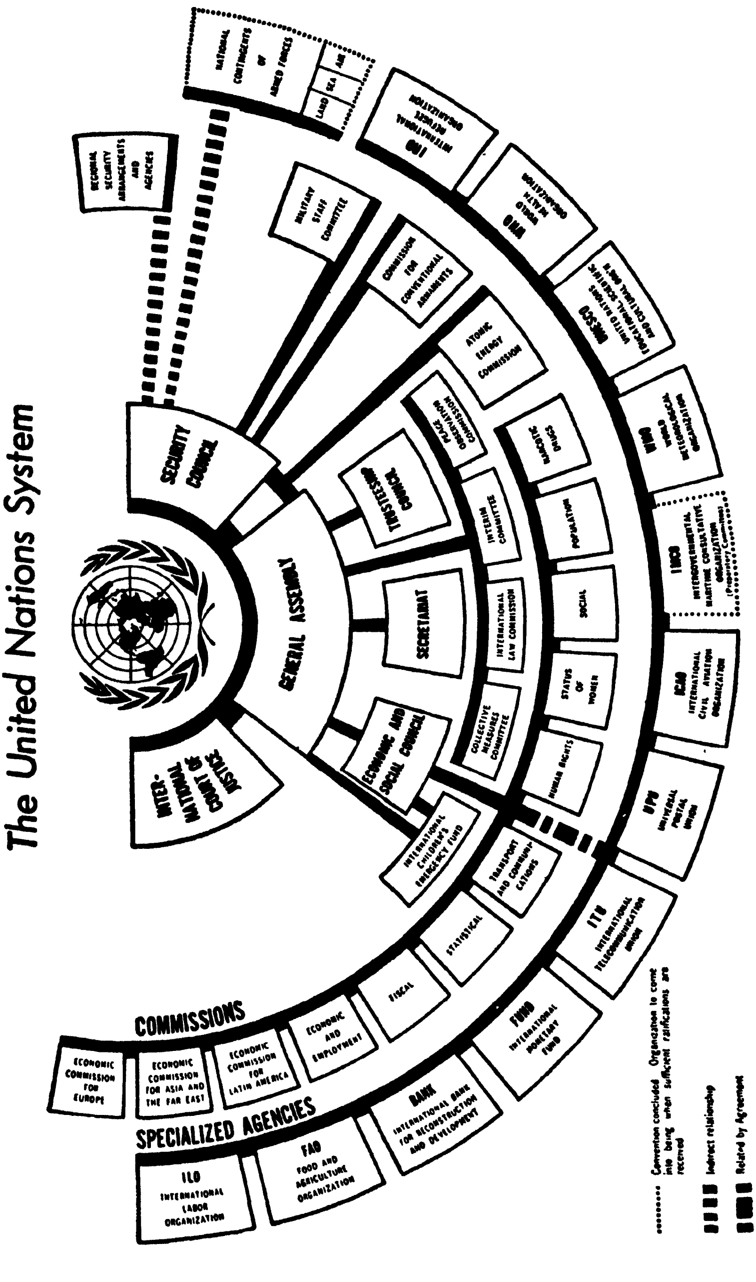


FIG. 7.—The United Nations System

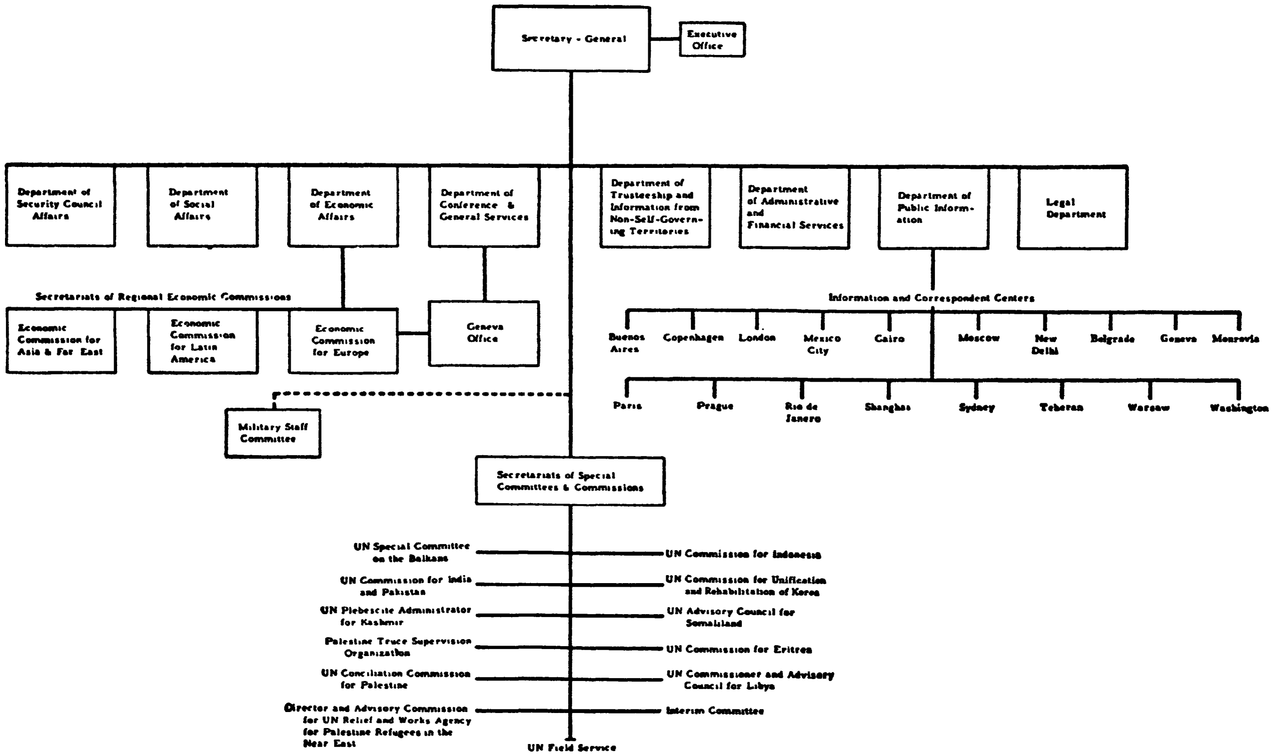


FIG. 8.—The United Nations Secretariat

the day-to-day work of the organization total approximately 10,000 persons, located in New York and other parts of the world. The structure of the United Nations system is shown in the attached chart (Figure 7). The organization of the Secretariat is shown in Figure 8.

The General Assembly is the basic body of the United Nations, to which each member country sends not to exceed five representatives and in which each member has one vote. Important decisions require a two-thirds majority of those present and voting. The General Assembly has authority over all matters within the scope of the charter. It initiates studies and makes recommendations to members in the interests of the maintenance of peace and of economic and political cooperation. It may not, however, make a recommendation regarding a dispute or situation while the Security Council is exercising the functions assigned to it regarding such dispute or situation, unless so requested by the Security Council.

The Security Council consists of eleven members and has primary responsibility for maintenance of international peace and security. The United States, United Kingdom, USSR, France, and China have permanent seats on the Council. The remaining six members are elected by the General Assembly. Article 42 of the charter provides that the Security Council "may take such action by air, sea, or land forces as may be necessary to maintain or restore international peace and security. Such action may include demonstrations, blockades, and other operations by air, sea, or land forces of members of the United Nations." Members in subscribing to the charter agree that they will carry out the decisions of the Security Council.

Each member of the Security Council has one vote. On all matters except those of procedure, a decision requires seven affirmative votes and these must include the concurring votes of the permanent members. Thus each of the five permanent members has, in effect, a veto on all important actions. It is this veto, used so frequently by the USSR, which has hampered the effectiveness of the Security Council and increased the im-

portance of the General Assembly regarding the maintenance of peace and security.

Economic and Social Council.—The Economic and Social Council (ECOSOC) is the principal organ of the United Nations in the field indicated by its title. The economic and social objectives of the United Nations are described in the charter as follows:

> With a view to the creation of conditions of stability and well-being which are necessary for peaceful and friendly relations among nations based on respect for the principle of equal rights and self-determination of peoples, the United Nations shall promote:
>
> a. higher standards of living, full employment, and conditions of economic and social progress and development;
>
> b. solutions of international economic, social, health, and related problems; and international cultural and educational cooperation; and
>
> c. universal respect for, and observance of, human rights and fundamental freedoms for all without distinction as to race, sex, language, or religion. (Article 55.)
>
> All Members pledge themselves to take joint and separate action in cooperation with the Organization for the achievement of the purposes set forth in Article 55. (Article 56.)

Responsibility for the discharge of the economic and social functions of the United Nations is vested in the General Assembly, and under the authority of the General Assembly, in the Economic and Social Council. The Economic and Social Council consists of eighteen members elected by the General Assembly. There are no permanent members. Each member has one vote, and decisions are reached by a majority of those present and voting. The structure of the Economic and Social Council is shown in Figure 9. The functions and powers of the Economic and Social Council are described as follows:

> 1. The Economic and Social Council may make or initiate studies and reports with respect to international economic, social, cultural, educational, health, and related matters and may make recommendations with respect to any such matters to the General Assembly, to the Members of the United Nations, and to the specialized agencies concerned.

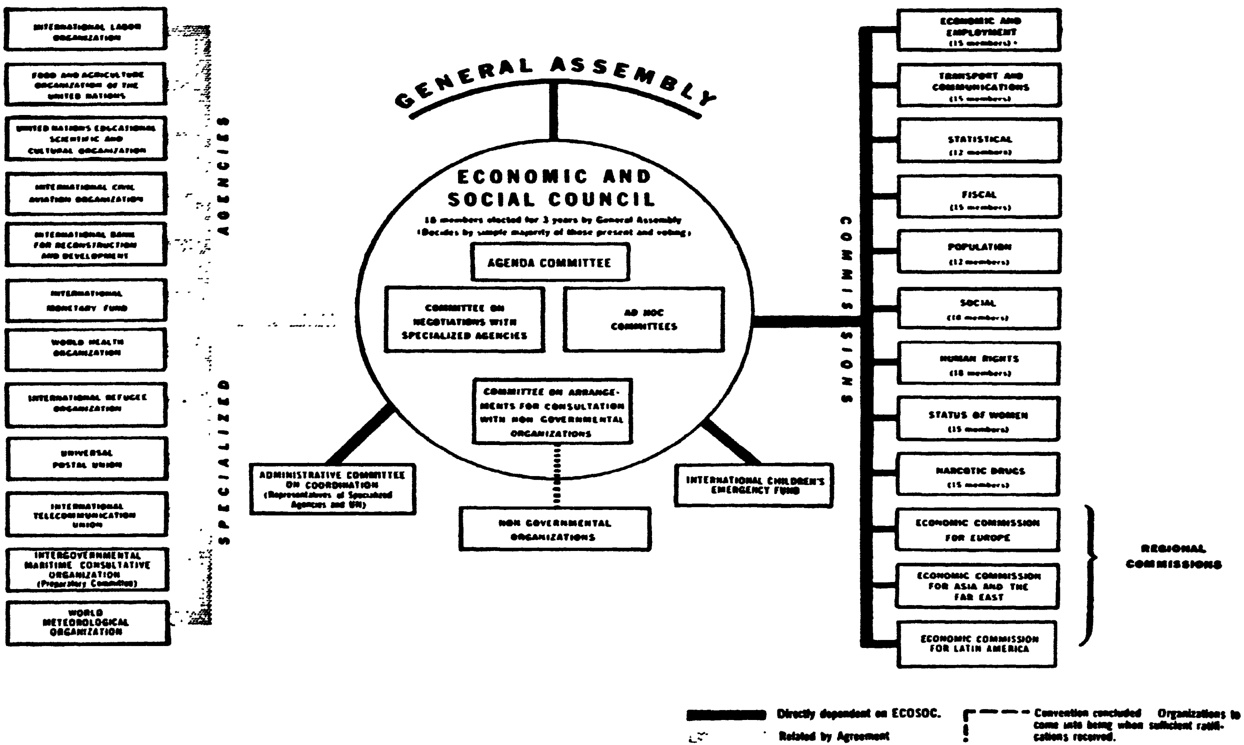


FIG. 9.—The Economic and Social Council

2. It may make recommendations for the purpose of promoting respect for, and observance of, human rights and fundamental freedoms for all.

3. It may prepare draft conventions for submission to the General Assembly, with respect to matters falling within its competence.

4. It may call, in accordance with the rules prescribed by the United Nations, international conferences on matters falling within its competence. (Article 62.)

The Economic and Social Council also "may coordinate the activities of the specialized agencies through consultation with and recommendations to such agencies and through recommendations to the General Assembly and to the Members of the United Nations. (Article 63.)

The Economic and Social Council, in order to carry out its duties, has established a number of committees and commissions. In July, 1951, it had nine functional commissions as follows:

Economic, Employment and Development Commission
Transport and Communications Commission
Fiscal Commission
Statistical Commission
Population Commission
Social Commission
Commission on Human Rights
Commission on the Status of Women
Commission on Narcotic Drugs

In addition to the functional commissions, the Economic and Social Council has established three regional commissions as follows: [10]

Economic Commission for Europe
Economic Commission for Asia and the Far East
Economic Commission for Latin America

The Economic and Social Council has given considerable attention to the promotion of economic development. It has made special studies of the general problem of economic de-

[10] A Commission for the Middle East has been proposed, but not yet established.

velopment and of means of financing such development. The Economic, Employment and Development Commission is instructed to have on its agenda at least once each year the question of financing economic development.

The United Nations, through the Council, is expanding its program of technical assistance concurrently with that of the United States. It has sent missions into underdeveloped countries to make surveys and advise with the government there on means to this end. The United States strongly supports the facilities of the United Nations for technical assistance, along with its own technical assistance program, and allocated to the United Nations $12 million of the first year's appropriation of $34.5 million provided by Congress for such assistance. Other countries pledged $8 million to make a total of $20 million for the United Nations program.

The Economic and Social Council has also been concerned with the problem of the prevention of unemployment and depression. The Council invited the Secretary General of the United Nations to appoint a group of experts to report on national and international measures to achieve full employment. This group met late in 1949 and prepared a report entitled *National and International Measures for Full Employment.* The recommendations of this report were concerned with domestic measures and with international measures The Council at its eleventh session held in Geneva in the summer and fall of 1950 considered the above report and after extended discussion adopted a significant resolution. This resolution recommended that each government publish annually a statement of its economic objectives, accompanied by a statement of quantitative goals or forecasts regarding employment, production, consumption, investment, etc.; that each government announce the policies and techniques which it intends to pursue in order to achieve these objectives, particularly "measures, such as the adaptation of fiscal, credit, monetary, investment, wage and price policies, to promote steady economic expansion"; that each government intensify efforts to achieve equilibrium in its balance of payments at the highest possible level of mutually beneficial trade, such trade to be characterized by (*a*) the ab-

sence of quantitative restrictions imposed on trade for balance of payments reasons, and of exchange restrictions on current account transactions, (*b*) a reduced level of other trade barriers, and (*c*) a minimum of discrimination. This resolution reads in part as follows:

290 (XI) FULL EMPLOYMENT

Report of the Group of experts appointed by the Secretary-General under Council resolution 221 E (IX) on national and international measures required to achieve full employment

Resolution of 15 August 1950

The Economic and Social Council . . .

A. WITH THE OBJECT OF ENSURING REGULAR SYSTEMATIC CONSIDERATION OF EMPLOYMENT PROBLEMS BY THE COUNCIL

1. *Decides* to place on the Council agenda once each year, beginning in 1951, for consideration in the light of economic trends, the problem of achieving and maintaining full employment with progressively improving levels of production, trade and consumption, and maintenance of or progress towards the achievement of equilibrium in balances of payments;

B. WITH THE OBJECT OF ENCOURAGING THE ADOPTION OF EFFECTIVE DOMESTIC FULL EMPLOYMENT POLICIES

2. *Recommends* that each Government:

(a) Publish annually a statement of its economic objectives for the ensuing year or for such longer period as may be appropriate, making special reference to the purposes set out in Articles 55 and 56 of the United Nations Charter, and being accompanied, wherever practicable, by a statement of quantitative goals or forecasts relating to employment, production, consumption, investment or such other pertinent measurable economic factors as may be significant indicators of the trends of its economy and

(b) Publish as soon and as precisely as is practicable the standard by which it defines the meaning of full employment as a continuing objective of policy, such standard being expressed, wherever possible, in terms either of employment percentages or of absolute numbers of unemployed

or in ranges of such percentages or numbers; and thereafter publish such revised standard as may become necessary from time to time;

3. *Recommends* that each Government formulate, announce, and periodically review, in the light of current and foreseeable economic trends, the policies, programmes and techniques which it intends to pursue for the purpose of achieving such objectives, goals and standards as it may set for itself under paragraph 2 above, with particular reference to:

(a) Measures, such as the adaptation of fiscal, credit, monetary, investment, wage and price policies, to promote steady economic expansion;

(b) Measures to combat recessionary tendencies, such as measures to influence the volume of investment, to increase the flexibility of budget and fiscal policies, and to prevent undue fluctuations in the incomes of primary producers;

(c) Special corrective measures, whether of a discretionary or of an automatic type, to meet emergency unemployment situations that may arise;

(d) Measures to avoid inflation and to prevent excessive increases in the price level; and

(e) Measures to promote the geographic and occupational mobility of labour;

4. *Recommends* that each Government keep continuously under review the adequacy of its organizational and technical arrangements, including statistical services, required for the formulation and pursuit of economic goals, policies and programmes and the analysis of economic trends;

5. *Recommends* that, in connection with the information required by the Secretary-General under Council resolution 221 E (IX), each Government furnish him, upon request, with full information concerning economic trends, the full employment standard, domestic economic objectives and—where appropriate—goals or forecasts, and domestic policies and programmes, as referred to in paragraphs 2 and 3 above;...

C. WITH THE OBJECT OF ENCOURAGING EFFECTIVE INTERNATIONAL FULL EMPLOYMENT POLICIES

I

9. *Recommends* that each Government intensify its efforts, while pursuing its employment and other domestic goals, to achieve and maintain equilibrium in its balance of payments; such equilibrium should be at the highest possible level of mutually beneficial trade and should be characterized *inter alia* by:

(a) Conditions of trade involving, along the lines envisaged in the relevant international agreements; (i) the absence of quantitative restrictions on international trade imposed for balance-of-payments reasons and of exchange restrictions on current account transactions (as defined in the Articles of Agreement of the International Monetary Fund), (ii) a reduced level of other trade barriers and (iii) a minimum of discrimination in the application of such trade, monetary or investment restrictions as may still exist;

(b) A level of reserves of convertible currencies and gold which would be sufficient to enable a country to meet normal fluctuations in its receipts of foreign exchange; and

(c) An increased and stable flow of international investment funds;

10. *Recommends* that each Government furnish the Secretary-General, upon his request, in connexion with its replies to the questionnaires being issued under Council resolution 221 E (IX) with estimates of its balance-of-payments position, and information on its related economic policies for the ensuing year and, when appropriate, for a longer period....

II

15. *Recommends* that Governments:

(a) Achieve and maintain, to the extent feasible, a high level and regular rate of flow of international investment capital for development purposes;

(b) Strive to prevent lapses in the flow of international investment resulting from or associated with economic recessions; and

(c) Continue to cooperate in efforts to achieve these results by both national and international measures;

16. *Recommends* that Governments:

(a) Seek to avoid, in their economic policies and programmes, measures which would be likely to have seriously adverse effects on the balance of payments or employment levels of other countries;

(b) In the event of a domestic recession, adopt, to the extent feasible, measures to offset the adverse effects of such recession on the balance of payments or employment levels of other countries; and

(c) Continue to cooperate in investigating ways and means for preventing domestic recession from spreading to other countries;

17. *Urges* the International Bank for Reconstruction and Development, while achieving and maintaining in ordinary times a high level and steady rate of flow of international investments for economic devel-

opment to utilize in case of recession, all practicable opportunities of increasing its resources, in order to expand the volume of its lending, *inter alia* by making fullest use of its borrowing capacity;

18. *Urges* the International Monetary Fund to make its resources available to its members to meet needs arising from economic recessions as fully and readily as its Articles of Agreement permit;...

24. *Recommends* that the Secretary-General and the appropriate specialized agencies provide, within their capacities, technical assistance to Governments, upon their request, for the purpose of carrying out this resolution.[11]

This action by the Council is an important step in efforts to prevent unemployment and depression, and to deal with the question comprehensively and on an international as well as a domestic basis. The Council's reiteration of the desirability of reducing exchange restrictions and other trade barriers is also significant. In accordance with this resolution the Secretary-General sent out to the member governments a questionnaire requesting the detailed information referred to in the resolution.

The Economic and Social Council carries on a variety of activities which cannot all be discussed here. The General Assembly on the recommendation of the Economic and Social Council established in 1946 the United Nations International Children's Emergency Fund. The Report of the Economic and Social Council for the Fifth Session (August 16, 1949, to August 16, 1950) describes the work of this Fund as follows:

The Fund's main activity is to provide supplies, in the form of food, clothing, medical supplies and equipment, to countries to strengthen their child care programmes. In addition, the Fund pays for technical advice and training related to government programmes assisted with UNICEF supplies, when such payment cannot be provided by the Government concerned or by other United Nation agencies. The requirements on the basis of which UNICEF aid is extended are the existence of: (*a*) a serious problem of child care; (*b*) plans for effective national efforts to meet the problem; (*c*) a necessity for some imported supplies as an integral part of the country's programme.

[11] United Nations Economic and Social Council, Official Records; Fifth Year, Eleventh Session, 3 July-16 August, 1950; Resolutions, Supplement No. 1.

By the middle of 1950 contributions and pledges to the Children's Fund totaled $148.6 million.

In addition to the various United Nations organs noted above, there are a number of independently created specialized intergovernmental agencies with responsibilities in particular fields. These specialized agencies have agreements with the United Nations defining their relations with the United Nations. The Economic and Social Council is charged with the responsibility of coordinating the activities of the specialized agencies, and receives regular reports from these agencies.[12] The specialized agencies with which the United Nations has agreements bringing them into relationship with the United Nations are as follows:

International Labor Organization
Food and Agriculture Organization
International Bank for Reconstruction and Development
International Monetary Fund
International Civil Aviation Organization
Universal Postal Union
International Telecommunication Union
United Nations Educational, Scientific and Cultural Organization
World Health Organization
International Refugee Organization

[12] Cf. Article 63 of UN Charter.

PART IV

THE COURSE OF INTERNATIONAL FINANCE

Chapter 39

INTERNATIONAL FINANCE, 1918-29

European Inflation After First World War.—After the Armistice in 1918, economic and financial conditions in Europe became progressively worse. Inflation existed throughout most of the world, but in some of the European countries was carried to such extremes that business came practically to a standstill. Under the extreme form of inflation which came to exist in several countries of Europe at this time, known as hyperinflation, thousands or millions of currency units were required in order to purchase what one unit would formerly buy. Conditions in some countries were so chaotic that, from the standpoint of noncombatants, the suffering of the postwar period was far more intense than that of the period of actual conflict.

Most neutral nations also suffered from inflation, and were seriously affected by the disarranged state of affairs throughout the world. By the end of the war, all the countries which had participated in the conflict and most of the neutral nations had abandoned the gold standard, which had previously existed widely, and were on an inconvertible paper-money basis, with varying degrees of inflated prices. The end of the war was not the end of their currency troubles.

In time of war, governments have two principal means of securing additional funds: taxation and borrowing. Taxes take time to levy and collect, while the money is needed promptly. Since it is difficult to raise by taxation all the money necessary, governments commonly borrow. Such borrowings usually result in an expansion of the monetary supply and lead to a rise in prices. The increase in monetary demand for goods and services can be checked through fiscal and tax measures,

limitations on credit expansion and measures to increase savings. The fiscal measures include both increased tax receipts and reduced expenditures. Bank lending can be discouraged and the public urged or compelled to save. Few of these measures, however, were effectively utilized during the first World War.[1]

During the first World War (also during the second World War), governments borrowed not only from the public's savings but in addition borrowed credit from the banks which did not represent savings. In most countries, banks provided deposit credits to the government against government bonds. This type of inflation is no different in its effects from direct issues of government paper money. This latter form of inflation—direct issues of government paper—was seldom availed of, but as a result of the former type of inflation commodity prices rose sharply, and in some countries during the early twenties went to fantastic heights.

The extent to which inflation prevailed in the different countries, particularly after the war, varied greatly. Although the Allied nations suffered severely, they suffered less from inflation than did the Central Powers. The United States, which did not enter the war until 1917, was the least affected by inflation. Nevertheless, between the spring of 1915 and the spring of 1920, the average of wholesale prices in this country increased by approximately two and one-half times. In Great Britain, wholesale prices more than trebled between 1913 and April, 1920. In France, during the same period, wholesale prices increased by almost six times, while in Italy the index number climbed to seven times the prewar level.

Following peak levels in the spring of 1920, wholesale prices throughout the world showed sharp declines. The decline, however, was temporary in France and Italy, where inflation continued; French prices eventually surpassed even those of 1920 and continued to rise until the stabilization of the franc in 1926.

The inflationary experience of the Allied countries was mild in comparison with that of Germany, Austria, Russia, and Poland, where hyperinflation was experienced. In Germany the inflation was particularly extreme, and the mark declined

[1] See Chapter 6.

in value until one trillion paper marks were the equivalent of one gold mark, worth about twenty-four cents in United States money. The mark was finally stabilized at this level in 1924. During the war, when the German Government used its credit-manufacturing power with relative moderation, the rise in prices was not serious. In the four years between 1914 and 1918, prices rose to something over twice the prewar figure. The relatively moderate rise in prices during the war years, however, was followed by violent and erratic movements during the next half decade.

After the Armistice, the German Government continued to rely on the central bank, the Reichsbank, for funds. The government needed money to pay reparations and for other purposes, and consequently borrowed heavily. The loans to the government were in the form of paper bank notes, which were printed and issued in huge amounts. This policy of meeting expenses by the printing of paper money, disturbing enough in 1918, had catastrophic effects by 1923. The pace of government borrowing and resulting currency expansion became ever swifter until in 1923, after the Ruhr occupation by France, the increases assumed fantastic proportions. The war had introduced figures of tens of billions, but postwar developments produced quintillions.[2]

The gigantic increase in the volume of money in Germany was accompanied by sharp increases in commodity prices. The fluctuations in prices from one day to the next were tremendous, and merchants even adjusted selling prices several times during a single day. Before the basketfuls of paper money received for an article could be counted, the money would have lost a part of its value. Amid such chaos business became all but impossible. The savings of thousands of people were entirely wiped out,

[2] The astronomical proportions of these figures make them difficult to read. Reichsbank notes in circulation increased from 22,188,000,000 marks at the end of 1918 to 113,639,000,000 marks by December 31, 1921, to 1,280,095,000,000 marks by the end of 1922, and to 497,000,000,000,000,000,000 marks at the end of 1923. Deposits, which during the war and first years after the Armistice had not risen as swiftly as the other items, overtook the increases in note circulation during 1923, increasing from 13,280,000,000 marks at the end of the war, to 22,327,000,000 marks two years later, and to the enormous total of 129,552,597,000,000,000,000 marks by November 15 1923.

because the savings were in terms of money which came to have practically no value. Countless instances existed of persons who put their money in a bank or invested it in securities, only to find that while their 10,000 marks (about $2,500) were still 10,000 marks, this amount would not buy a newspaper.[3]

The mark was finally stabilized in 1924, as noted below, at a rate of one trillion of the former paper marks, to one of the new so-called Reichsmarks, worth about 24 cents in American money.

The Problem of Currency Reform.—The acute disruption resulting from the currency chaos made clear the need for a return to monetary stability. The international financial conferences held at Brussels in 1920 and at Genoa in 1922 recommended a prompt return to the gold standard. The disastrous uncontrolled inflation in Central Europe, which shortly followed, emphasized the necessity of stabilizing currencies.

The gold standard was generally regarded at this time as the end toward which efforts should be directed. A considerable time elapsed, however, before the nations of the world finally returned to a gold basis, and it was a different kind of gold standard than that of the prewar years.

The war had left in its wake many financial problems. In the first place there was the large amount of depreciated paper currency outstanding. Furthermore, gold was unevenly distributed, the United States having about half the world's monetary gold. European officials felt that their reduced gold reserves were insufficient to support a return to gold. Moreover, the previous unsatisfactory nature of the gold standard led some economists to urge that a managed currency system be adopted by the leading nations in place of gold.

A serious difficulty was the inflated price levels which prevailed because of the large amounts of currency outstanding. Even if the gold reserves of the countries had been as large as before the war, they still would not be ample to support all this

[3] For further data relating to the war and postwar inflations, see John Parke Young, *European Currency and Finance* (Washington, D. C.: Government Printing Office, 1925), Vols. I and II.

new money at the old gold par. To retire some of the money would be expensive, and would cause serious deflation, falling prices, incomes, and consequent depression.

The alternative to resumption of gold payments on the prewar basis (which was out of the question) was devaluation of the gold unit, i.e., reduction of its gold content to a point in harmony with the currency's lower purchasing power. Devaluation, however, was extremely unpopular and was regarded as an admission of financial weakness by the government. The public, not understanding devaluation and that the depreciation of the currency had already taken place, was greatly opposed to this step. Even though the necessity of devaluation was clear to currency students if the gold standard was to be restored, government officials found the question so delicate that in most countries they were unable even to admit devaluation as a possibility. They frequently professed that the old par would be restored.

The uneven distribution of gold was regarded as a serious barrier to the proper functioning of the gold standard. At the end of 1924, the United States held about $3 billion of gold, which was a large amount for that period—over half the monetary gold of the entire world. Most of this had come to America since 1914. Much the larger part of the remainder of the world's monetary gold was divided about equally between England and France. The United States received gold largely because this country had exported heavily to Europe prior to this country's participation in the war, during its belligerency, and after the war. In lieu of goods and services, large quantities of gold flowed to America in partial payment of purchases by Europe. In the space of about three years, the United States was transformed from a net debtor nation into a substantial creditor. The stability and relatively safe position of this country also attracted millions of dollars in gold after the war for investment and safekeeping.

Another condition which caused economists to doubt whether the gold standard would function satisfactorily was the possibility of large and sudden capital movements. It was feared that, in the event of a return to gold, pressure would be placed

on different currencies in order to transfer capital, and that demands for certain currencies, like runs on banks, would take place and deplete reserves. Subsequent experiences along these lines are noted below.

Great Britain and Other Countries Return to Gold.—The United States, which in 1917 had placed an embargo on gold exports and suspended gold redemption, returned to gold in 1919. During the next four years, the United States was the only leading country on a gold basis, and the dollar acquired a great deal of prestige; possession of dollars was much desired by persons in Europe and other parts of the world. Between 1924 and 1928, however, almost every important nation went back to gold.[4]

The German mark was stabilized and placed on a form of the gold standard in 1924, as arranged by the Dawes Plan. Currency stabilization in Germany was the turning point from chaos to reconstruction and subsequent prosperity for Germany, and in fact for most all Europe.

Great Britain finally returned to gold in April, 1925, at the prewar par of exchange, $4.86 in United States money, and was immediately followed by several other countries. Since exchange rates had been below par preceding this event ($4.77 immediately preceding), the effect of the return to gold was to make the pound more expensive in terms of foreign currencies and, therefore, to make British goods more costly to foreigners. The effects of this situation, expensive British goods, were much as would be expected; namely, it tended to discourage British exports. This was depressing to British industry, already troubled by postwar readjustments at home and abroad, including a loss of export markets. A downward adjustment

[4] The postwar return to gold may be summarized as follows: Lithuania and Latvia adopted a gold standard in 1922; Germany, Sweden, and Hungary returned to gold in 1924; England, Holland, the Dutch East Indies, Australia, New Zealand, South Africa, Switzerland, and Austria in 1925; Finland and Belgium in 1926; Denmark, Czechoslovakia, Poland, and Italy in 1927; France and Norway in 1928. The principal major nations which did not adopt gold in these years were Brazil, Spain and Turkey, which remained on an inconvertible paper basis, and China and Persia, which maintained a silver standard.

of prices, wages, and profits was necessary in order to make the pound worth the par value of $4.86.

It was felt by some persons that a new and lower par, $4.50, for example, would have been more in harmony with the prevailing price level in Great Britain and the country's trade position, that this would have stimulated exports, been easier to maintain, and would have brought greater prosperity to the country.

The return to gold at the old par was strongly opposed by the British Federation of Industries and by the British economist, John Maynard Keynes. Keynes, who had originally advocated reestablishment of the gold standard, in 1923 urged the adoption of a managed paper standard. He believed that resumption of gold payments at the former par would create unnecessary unemployment, and that Britain's new position of debtor to the United States would make it impossible for the gold standard to function with its prewar smoothness even if gold payments were resumed at a reduced par of exchange.[5]

Subsequent experience convinced many economists that Great Britain made a mistake in returning to the prewar par. Partly because of this action, British industry was in a state of chronic depression, with severe unemployment, until after gold was again abandoned in 1931. Had Great Britain pursued a policy of tighter money and deflation during these years, the country could probably have maintained the gold standard, but such a policy would have added to the domestic depression and unemployment.

France Returns to Gold.—The currency situation in France after the war was quite different from that in Great Britain. With the outbreak of the war in 1914, the franc was detached

[5] In February, 1925, Keynes wrote: "Those who think that a return to the gold standard means a return to these conditions (the pre-war currency conditions) are fools and blind. We are now the debtors of the United States. Their foreign investments last year were double ours, and their true net balance available for investment was probably ten times ours. They hold six times as much gold as we do. . . . A movement of gold or of short credits either way between London and New York which is only a ripple for them, may be an Atlantic roller for us." *Essays in Persuasion* (a collection of previous articles) (New York: Harcourt, Brace & Co., Inc., 1932).

from gold, but was pegged for the duration of the conflict, largely through British and American financial assistance. When the war was over, artificial support was withdrawn, with the result that the franc began to decline rapidly in the foreign exchange markets. Furthermore, inflation in France continued for several years, commodity prices rising higher and higher, and franc exchange falling continually lower. Expecting that Germany would pay the bill, France poured huge sums of money into the reconstruction of its devastated areas. As a result of these and other expenditures, the national budget was in a badly unbalanced condition, the deficits being met by inflation. The financial disorders in France and the weakening of the franc stimulated the wholesale outflow of French capital. This occurred during the years 1919 to 1926. French capitalists, desirous of maintaining their funds intact, transferred them to countries with stronger currencies. This outflow of capital, causing a strong demand for foreign currencies, pushed the franc still lower in the exchange market. At the same time, the franc was a target for international exchange speculation, because of expected further declines. This was unsettling and tended to hasten the downward process.

To many persons France appeared to be headed for a currency debacle similar to that of Germany two years before. The budget was unbalanced and the deficits were being met by inflation. The franc had dropped in the exchange markets from about 19.3 cents in American money (the prewar gold par) to approximately 2 cents by July, 1926. A National Union Ministry was formed on July 23, 1926, and Premier Raymond Poincaré emphasized that only through greatly increased taxation and strict governmental economy could the fall of the franc be arrested. His appeals were heeded by the legislature; high income taxes were voted, and the budget was balanced for the first time in thirteen years.

With fiscal order achieved, the franc rose in value to about 4 cents by the end of 1926, where it was stabilized on a de facto basis. This rise in value was not the result of a contraction of the circulation, but accompanied a slowing down in the rate of circulation as confidence returned, an increase in the internal

demand for francs. The circulation actually expanded greatly after stabilization. In 1928, France officially returned to the gold standard, the gold content of the franc being fixed at the equivalent of about 3.92 cents. This act of devaluation was legal recognition of depreciation which had already taken place. With stabilization accomplished, the outflow of French funds was reversed, and capital began to return to France on a large scale. The gold reserve was built up and the Bank of France acquired large balances abroad as funds abroad were exchanged for franc currency.

The value at which the franc was stabilized, unlike that of the pound, was low in comparison to the price level and to costs within France. This was largely because foreign exchange depreciation had outrun internal depreciation. The low value at which the franc was stabilized was partly responsible for the flow of gold into France, and for the prosperity which followed. However, after the chaotic period in France, accompanying the currency disorders, stabilization in itself would contribute powerfully to improved conditions. Although the British pound had been unstable, it had not experienced the extreme fluctuations, with the consequent disturbing effects of the French franc.

The new low value of the franc was easier to maintain than if a higher value had been selected. It aided French exports, which together with the return of French capital, helped the Bank of France to build up its foreign balances. The Bank of France paid out paper francs as it bought drafts in foreign currencies, the drafts being presented by persons who wished their capital back in France. It thus came about that after stabilization the circulation continued to expand. This expansion prevented the franc from rising in the exchange market.

The Postwar Gold Standard—A Period of Currency Exploration.—The gold standard of the 1920's differed materially from the type which prevailed before 1914. After the war, European nations found themselves with depleted gold reserves, as a result principally of the large European purchases abroad not offset by exports. Gold had been exported to buy necessaries. The currency reforms, therefore, had to contend

with small gold reserves, and consequently were of a type involving economy in the use of gold. The term gold standard came to be applied to any arrangement wherein the unit was in actual fact maintained at a fixed relationship to gold, regardless of whether it was backed by gold, was redeemable in gold, or whether gold could be exported and imported freely.

Before the war, gold coins were used freely in domestic transactions. This condition was believed by some persons to be an indispensable requirement of a full gold standard. During the war, however, gold disappeared completely from hand-to-hand circulation, driven out by the large amount of depreciated paper money. When the gold standard was restored after the war, in few countries did the government make gold coins available for general circulation. With the exception of the United States, in practically no country was it possible to obtain gold coins in exchange for paper money.

The so-called *gold bullion standard* was adopted by England, France, and other countries. According to this standard, redemption in gold was possible only in large amounts, and the gold did not need to be in the form of coin but could be in gold bars.[6] This device obviously prevented gold from circulating internally. In the United States, no restrictions were placed on redemptions in gold coin, or upon the coining of gold, but during the first World War the American public learned of the greater convenience of paper money, and had no desire for gold coin when it was again available.

A significant aspect of postwar currencies was the widespread use of what was similar to the *gold exchange standard.* Employment of this standard was usually on a de facto basis, without the formal regulations of the prewar gold exchange standard as it existed, for example, in the Philippines and Nicaragua. No hard and fast line could be drawn between the gold exchange standard as employed after the war, and the regular gold standard as this standard then came to be understood.

[6] In Great Britain, the Bank of England was obligated to pay out gold in return for legal tender money in amounts of not less than 400 fine ounces—about $8,268 in American money of that period.

The prewar type of gold standard completely passed out of existence, although it continued in the United States until 1933.

The principal characteristic of the gold exchange standard is, essentially, that the currency is maintained at a constant value in relation to gold through redemption, not in gold at home, but in drafts upon a foreign country in which gold is freely available. Formal arrangements may be determined by law, and may provide that a reserve be maintained abroad in the form of a deposit, payable in gold, and that drafts be sold by the government or its agency against this deposit at prices which can fluctuate only within a narrow range, corresponding to the limits that would be set by the gold points if the full gold standard prevailed, and that the currency received be withdrawn from circulation as though gold had been exported.

The gold exchange standard as employed by the European countries after the war was a loose arrangement wherein these countries built up large deposit balances in dollars in New York and in pounds in London. They stabilized exchange rates on these gold standard centers by either buying foreign drafts with local currency, or selling drafts on these foreign deposits, according to whichever was required to maintain stability of exchange rates. They were thus in a position to enter the exchange market on either the demand or supply side. When necessary, the foreign deposits were often strengthened by means of loans or credits received from the foreign financial center. While these deposits abroad were not gold, but merely debts of foreign banks payable in gold, the government or its central bank, which had title to them, often counted them as gold, and sometimes even showed them as such in the balance sheet. Transactions at rates other than the established rate were not illegal—in contrast to arrangements under exchange control developed later—but were unprofitable so long as the government was prepared to buy or sell exchange at the established rate.

This system of deposited reserves put a heavy responsibility upon New York and London, where most of such deposits were kept. In 1931, when large withdrawals of funds from London

took place, the strain became too great and Great Britain was compelled to suspend payments in gold, as noted below. After Great Britain left gold, the United States was subjected to large-scale withdrawals, which were successfully met, although the outflow of gold was at times large and threatened the American gold standard.

The postwar system of exchange rates, wherein rates were controlled by government buying and selling of exchange, replaced the former system of exchange rates which were subject to automatic controls exercised by gold movements. Formerly, when rates on a foreign country tended to appreciate the foreign currency, gold was exported to take advantage of the premium on exchange, and the supply of the foreign currency was thereby increased as drafts were drawn against this gold. Conversely, if a foreign country's exchange tended to depreciate, gold was imported from such a country. Rates were held within the gold points as discussed in Chapter 5. The inflow and outflow of gold had important effects upon interest rates, monetary and credit conditions, price levels, incomes, and the flow of trade. An inflow of gold tended toward easy money, larger incomes, and higher commodity prices, while an outflow tended toward tighter money, smaller incomes, and lower prices. This mechanism and the role of income movements in balance of payments adjustments were discussed in previous chapters.

When the above semiautomatic forces were replaced by the system of controlled exchange rates, and when internal credit policies were no longer guided by the condition of the exchange market and monetary reserves, but were determined according to domestic needs, balancing adjustments frequently did not take place or were inadequate to bring equilibrium between international payments and receipts at the established rate. In view of the role of income movements in promoting a balance in international accounts, however, the separation of domestic credit policy from gold movements, or even the banking measures sometimes adopted to neutralize such movements, frequently did not prevent a tendency toward a balance. For example, larger exports might result in increased incomes (in

the export and other industries), and lead to larger imports. The condition of lack of balance which often existed for whatever reason (price level movements were important factors in the balance of payments during this period), tended to deplete reserves and to put a strain on the maintenance of the fixed rate and the gold standard. Some currencies during this period were under continuous pressure in the exchange market due to balance of payments deficits.

When it became necessary to choose between the maintenance of a fixed exchange rate, and the aim of internal economic stability, most nations chose the latter. The internal stability sought was thought of at that time primarily in terms of price level stability. The internal conditions involved, however, were in fact much broader and embraced employment and the national income, as was realized during the 1930's.

During the 1920's, after currencies had once been stabilized, countries were usually able to hold these rates in spite of the developing maladjustments. The maladjustments did not assume a serious form until the depression of the 1930's, with its uneven effects upon different countries and upon foreign trade. Had the depression not been allowed to become so severe, it is probable that the balance of payments maladjustments would have been correspondingly less, and that exchange rate movements would have been considerably narrower. In other words, the divorcing of credit policy from balance of payments conditions was probably not the principal reason for the extensive exchange rate fluctuations which subsequently took place.

The currency systems of the 1920's, wherein domestic currency and credit policies were largely divorced from gold movements and the state of the foreign exchanges, marked a beginning of the later policy of placing first emphasis upon internal conditions, even though this meant fluctuating exchange rates, or, as was later the case, meant the placing of restrictions on the purchase and sale of exchange and a consequent narrowing of trade. But first the world was to suffer from unprecedented economic instability, deflation, depression, and a currency and exchange debacle.

Foreign Lending and Balance of Payments During Twenties.—During the postwar years a large amount of international lending took place, particularly on the part of the United States. For several years this country was loaning to foreigners at the rate of between one and two billion dollars a year. These loans provided foreign countries with a generous supply of foreign exchange without having to export merchandise or render services. The countries were thereby enabled easily to maintain exchange rates in spite of heavy imports and an otherwise unbalanced condition in foreign payments and receipts. Foreign loans, by providing for deficits in a country's foreign payments, thus tended to conceal strains, and to prevent maladjustments from asserting themselves, or necessary adjustments from being made to promote equality between debits and credits.

American exports were financed to a large extent by American loans to foreigners, since imports into America were insufficient to pay for the large outflow of goods. The inflow of gold also helped to finance exports. America, however, was a substantial creditor, and as such should have been receiving large amounts of goods and services from abroad to facilitate interest payments. The American high tariff policy, discussed in another chapter, discouraged the sale of foreign goods to America, and thereby contributed to the maladjustment and to the inflow of gold. It interfered with the needed expansion of exports by other countries in their trade with America.

German reparations, a heavy burden upon Germany, were transferred to the creditors partly by means of extensive German borrowings from abroad instead of by the exportation of German goods. So long as debtor nations could without much difficulty secure whatever short-term and long-term credits they needed from foreign countries, exports and imports did not need to balance, and the world's economic life to outward appearances proceeded fairly smoothly. Foreign exchange rates were stable. When the collapse finally came, and foreign lending ended, exchange rates were under pressure and depreciated. Loans were not available to take up the slack in the foreign accounts of countries that were current debtors. Moreover, depression and economic disorders intensified foreign exchange instability.

German Reparations.—Prior to the first World War, large indemnities had been paid in modern times by France and China. A payment of 5,000,000,000 francs (about one billion dollars) was collected by Germany following the Franco-Prussian War of 1871. German troops occupied France until this sum was paid. Following the Sino-Japanese War of 1895 Japan collected from China an indemnity of 200,000,000 taels (about $170,-000,000 at that time).

When the United States entered the first World War in 1917, it declared against the principle of indemnities. However, upon the defeat of Germany and the other central powers in 1918 the Allied nations did not concur in the position taken by the United States. France, whose territory had been ravaged, needed financial help for reconstruction.[7]

In the Treaty of Versailles Germany was forced to accept responsibility "for causing all the loss and damage to which the Allied and Associated Governments and their nationals have been subjected as a consequence of the war imposed upon them by the aggression of Germany and her allies." Germany was also required to agree to pay the entire war debt of Belgium and to "make compensation for all damage done to the civilian population of the Allied and Associated Powers and to their property during the period of belligerency of each. . . ."

At the Peace Conference in 1919 the Allied nations were unable to agree upon the amount of the bill for reparations to be presented to Germany. Extravagant sums were proposed, far beyond Germany's capacity to pay. One group wanted the amount left elastic, so that as Germany recovered from the war, reparations could be adjusted. The treaty finally provided that a Reparation Commission be established and that this commission determine what the total bill was to be and how it was to be paid.

The Reparation Commission accordingly announced in April, 1921, that Germany should pay 132,000,000,000 gold marks, the equivalent of $32,000,000,000. This was in addition to the Belgian war debt. Serious students knew that this enormous

[7] For a discussion of the war debt situation see Chapter 34.

amount would never be paid. Germany was to begin payments immediately at the rate of $750,000,000 a year.

Germany paid upon this basis until 1923, but with the greatest of difficulty. She paid in cash, in coal, in ships, in railway equipment, in livestock, and even in works of art. In order to get the necessary money with which to buy foreign drafts to be turned over to the Allied powers, Germany printed quantities of paper marks. The mark circulation rose to the unpronounceable figure of about 500,000,000,000,000,000,000 at the end of 1923. The value of the mark—24 cents before the war—declined accordingly to a point where it took 100,000,000,000 marks to buy a newspaper. Economic conditions in Germany by this time had become critical. The chaos was extreme and business came almost to a standstill.

On January 9, 1923, Germany was declared in default on reparations. France and Belgium promptly (January 11, 1923) marched their troops into the Ruhr Valley and took possession of this rich part of Germany. Great Britain had vigorously opposed such a drastic measure. Sentiment in the United States was largely with Great Britain, the public feeling that Germany was being pressed too hard. France, on the other hand, felt that Germany was not making a sincere effort to pay. Germany was desperate over the situation, but no action was possible on her part.

Throughout all Europe conditions were greatly disturbed, both economically and politically. Inflation and its severe hardships had ravaged most of the countries. Bread riots and other forms of violence reflected the intense suffering and low morale of the people. The postwar period saw more real suffering among the noncombatants than the period of actual conflict.

The United States during these troublous times had withdrawn from European affairs, with the result that Germany was bitter toward the United States. The idealism of President Wilson seemed to her merely empty words. In France persons charged the United States with deserting Europe at a critical stage. The United States had come over, taken the glory of winning the war, and gone home without helping to set things in order. Great Britain felt that the United States should throw

its influence with her in her efforts for moderation. In the United States, political squabbles confused the people and kept this country from taking an active part in solving these international problems so intimately related to the country's own well-being. As soon as the war was won many persons in the United States seemed to think the job completed, and that the objectives for which their country had fought, "making the world safe for democracy," would be attained automatically.

The United States, it has been noted, early declared against indemnities in principle, and at the Peace Conference refused to accept a share of reparations. From this country's standpoint, therefore, the reparation problem had always been distinctly a European problem. The United States had no member on the Reparation Commission although it did have an observer who sat with the Commission.

In December, 1922, Secretary of State Hughes made a speech in New Haven in which he declared that the reparation problem was an economic and financial one, and should be taken out of the hands of diplomats and politicians and turned over to a group of experts who should decide what Germany was able to pay and how she might pay.

Europe, looking anxiously to America, seized upon this statement of the Secretary of State as an offer of help. America at last was willing to cooperate, provided reparations were taken out of politics, a condition not easy to satisfy. As the failure of the Ruhr expedition became apparent, discussion between the United States and Europe led to the appointment of the so-called Dawes Committee of experts by the Reparation Commission. The three American members were private citizens but served with the blessing of this government, which assisted in their selection.

The Dawes Committee.—Representatives of the different powers assembled in Paris early in January, 1924, and promptly elected Charles G. Dawes, of the United States, Chairman. One of the main problems was to determine how the resources of Germany could be availed of to pay the Allied nations. Conditions in Germany were chaotic at that time and an important

immediate problem was the stabilization of the German currency and the rehabilitation of the country generally.

After two or three months of intensive work the Committee made its recommendations, which became known as the Dawes Plan. The Dawes Report wisely did not attempt to determine the total amount of reparations that Germany should pay, but undertook to decide merely what Germany could pay each year in the immediate future. The Plan provided for small payments the first year or two, working up to about $625,000,000 the fifth year, 1929, which was to continue indefinitely. The Plan also provided that a portion of the payments should be made in kind, that is by handing over actual goods. This, it was thought, would facilitate the transfer of the payments from Germany to the Allied nations. The transfer problem received serious attention, many persons feeling that the amounts Germany was required to pay were greater than could be transferred to the other nations without causing a breakdown of foreign exchange rates and other difficulties. To deal with this contingency, provision was made that in the event that the money could not be transferred without causing the mark to depreciate, as marks were offered for francs, pounds, etc., the money should be held within Germany, accumulating to the credit of the Allied nations.

In order to assure an adequate supply of funds within Germany, certain revenues were earmarked for reparation payments. Several foreign commissioners were appointed to supervise matters. The Plan also provided for the reform of the German Reichsbank and the stabilization of the currency.

The Dawes Report was accepted by Germany and the other nations involved, and promptly put into force in the fall of 1924. General recovery in Germany and throughout Europe followed rapidly. In order to initiate the Plan, Germany borrowed about $200,000,000 in the world capital market. The fact that Germany was able to float a public loan of this size indicated the extent to which her credit was restored.

The Young Plan.—The Dawes Plan was recognized at the time as a temporary measure for two reasons. It provided no end to reparations, the total having been left indefinite in the

interests of harmony, and it set up an elaborate system of supervision over Germany's financial affairs. This was offensive to German pride; reparations themselves were also greatly resented. Finally, late in 1927, the Commissioner of Reparations, an American, said it was time Germany be told what was expected of her and that she be allowed to run her own affairs. The Allied nations and Germany agreed that a new committee be established to prepare a final solution to reparations.

Accordingly, the so-called Young Committee was appointed and met in Paris in February, 1929. The Chairman of this committee was Owen D. Young, an American, who had also been a member of the Dawes Committee. As a result of this new conference, reparation payments were considerably scaled down, and were to continue until 1988, the average yearly payment amounting to $474,000,000.

The Young Plan had scarcely begun to function when economic depression seized the world. Germany's revenues declined, as did the country's foreign trade. German finance began to creak under the load. Germany had borrowed heavily abroad, especially in America, in the years following the Dawes Plan, and now had large foreign payments to make in addition to reparations. These foreign borrowings amounted to between four and five billion dollars, about half of which were repayable upon short term. Much of the money, however, was invested in long-term undertakings, both public and private. The merchant fleet was reconstructed, many industries modernized, and towns carried through programs of public improvements.

When the foreign creditors, financially involved at home and nervous over Germany's condition, asked Germany to remit, she was unable to meet their demands. She exported some of her gold reserve, but this did not suffice. Great Britain, to her own undoing, loaned Germany money in the attempt to hold things together.

Chapter 40

INTERNATIONAL FINANCE, 1930-39

The International Financial Collapse of 1929-33.—The restoration of the gold standard throughout the world during the 1920's and the reconstruction of economies were followed within a few years by a general abandonment of gold, and by the most severe and extensive depression and economic disorders the world had experienced.

After the second World War a realignment of political boundaries and the creation of new states had altered radically the accustomed flow of trade. In many countries tariff and other barriers were raised to unprecedented heights, with consequent disturbing effects upon trade and the balance of payments. The war and its aftermath had altered the productive facilities of many countries and had also affected markets. In addition, large transfers of capital were taking place with important effects upon countries' foreign accounts. Gold, as a result of wartime purchases and of these conditions, was unevenly distributed. The monetary and fiscal policies of most nations were not guided by gold or the balance of payments position, as noted in the last chapter, but were based largely upon domestic considerations. Foreign lending, moreover, covered up maladjustments in trade balances, and concealed the underlying disequilibrium. Speculation in securities, real estate, and other assets had become rampant in many countries accompanying the world-wide boom. This was the background for the economic events which began late in 1929.

The world realized that perhaps something was wrong when the stock market in America suffered drastic declines beginning in October, 1929. Prior to the stock market crash, business throughout the world had begun to slow down, and to many

persons strains were apparent. Conditions in America and elsewhere soon went from bad to worse, and the entire world became engulfed in unprecedented depression, financial and economic collapse. The price levels of all countries declined drastically as can be seen in Figure 10 on page 753. Social and political disorders grew out of the economic disturbances and the widespread discontent. Autarky and economic nationalism were promoted. The economic unheaval facilitated the progress of the Nazi system and German aggression.

The Credit-Anstalt Affair.—Early in 1931 there were signs of recovery, but in May, 1931, events took a sharp turn for the worse. The occasion for the relapse was the failure, on May 11, of the prominent Austrian Credit-Anstalt, a Rothschild-controlled bank in Vienna; the condition of the bank had previously been beyond suspicion. The failure was precipitated by a panic which followed the writing down of the bank's assets as dictated by the altered financial situation and the decline in values. The bank, in the spring of 1931, had revalued its assets, consisting largely of securities and loans. Austrian depositors, worried by the apparent change in the bank's condition, demanded their funds, with the result that a run on the bank developed, and forced suspension of payments.

In order to understand the failure of the Credit-Anstalt, it is necessary to understand the European political situation existing in the spring of 1931. France was opposing vigorously the Anschluss, or customs union, between Germany and Austria. In order to prevent the consummation of this customs union, France brought financial pressure upon Austria, which contributed to the collapse of the Credit-Anstalt. This failure was followed by a train of other troubles in a financially unstable Europe, finally involving the entire world.

The Austrian Government promptly came to the aid of the Credit-Anstalt, but found difficulty in securing the funds needed to cover the deficit of the bank. The government arranged to issue Treasury bonds to obtain the needed money. The French authorities had agreed in May to participate in the loan, but subsequently stated that they would do so only provided Austria

abandon plans for the customs union. France did not desire any consolidation of Germany and Austria. The Austrian Government, however, was not willing to abandon the customs union. To protect Austria's creditors and the solvency of the country, the Bank of England came to the rescue with a credit of £5,000,000. The Bank for International Settlements also aided. The customs union was not popular in England, and the motives behind the Bank of England's action were apparently financial rather than political. In September a crisis in London forced the Bank of England to request repayment of the credit.

In the "standstill" agreements (Stillhaltung), which followed the troubles in Austria, foreign creditors of the Credit-Anstalt and other Austrian banks accepted a two-year moratorium on their claims. The purchase and sale of bills of exchange were placed under control of the Austrian Government in order to limit exchange fluctuations; this inaugurated exchange control in Austria.

German Financial Crisis of 1931.—Financial affairs in Europe continued to grow worse. American banks began to withdraw funds from Germany and Central Europe as a result of the trouble in Austria. British, Swiss, and Dutch banks soon did the same. The German Reichsbank was compelled to part with large amounts of gold in order to maintain the stability of the mark. The Reichsbank received support from the Bank for International Settlements, the Bank of England, Federal Reserve Banks in the United States, and the Bank of France.

The support, however, was inadequate, and the short-term credits granted were soon exhausted. The Bank of France was in a position to extend additional credit, but as a condition demanded that Germany abandon the customs union with Austria and the construction of a cruiser. This Germany was unwilling to do. On July 13, 1931, the important German Darmstaedter und National Bank failed, the second largest bank in Germany. This failure was followed by a series of important bank failures throughout Central Europe and elsewhere. As a result of the crisis Germany stopped payment on her external short-term

credits, as arranged in "standstill" agreements, and instituted control over foreign exchange operations.

In an effort to relieve matters and halt the world depression, made more severe by the crisis in Europe, President Hoover, on June 20, 1931, announced his proposal for a one-year moratorium on reparations and war debts. This bolstered confidence temporarily, but did not get at the root of the trouble, as subsequent experience showed. The crisis had assumed serious proportions, and conditions throughout the world continued to be grave.

From Central Europe the scene of crisis shifted to London, resulting in the collapse of the pound, with far-reaching repercussions. Then eyes turned on the United States, and this country was subjected to heavy pressure. It was able, however, to stand against the tide and maintain the dollar on a firm basis, paying all foreign creditors as demanded. Subsequently the United States deliberately took the dollar off the gold basis, by choice of the new Administration and not because the gold standard could no longer be maintained.

The part played by French politics in the international financial crisis has been the subject of debate and criticism. It was charged that France was using financial weapons to accomplish political ends, and contributed much to the financial and economic chaos of that period. If these charges are correct, it is also undoubtedly true that France did not realize how great the consequences were to be, and that she herself would later be engulfed in the financial maelstrom, and subsequently become the victim of German aggression which was furthered by the economic chaos.

Financial conditions throughout the world were already dislocated, so that French policy cannot be held responsible for all that subsequently happened. France is condemned harshly by Paul Einzig in his book *Behind the Scenes of International Finance*. He says, "the financial warfare conducted by France in order to acquire political power over Europe has largely contributed to the development of the economic depression since 1929, and has been the direct cause of its accentuation during

the second half of 1931 into a crisis without precedent."[1] He presents a severe indictment of French foreign policy.

Hoover Moratorium.—The world depression became increasingly severe, and many people believed that reparation and war debt payments were somehow a factor. Suddenly, in June, 1931, in order to help relieve the situation, President Hoover announced that the United States would postpone for one year all payments of interest due it on the war debts, provided the European nations would similarly postpone all their intergovernmental payments. The Hoover moratorium, as noted in Chapter 34, was soon an accomplished fact, taking effect the first of July, 1931. France was hostile to this move, but found no other course possible than to cooperate. France knew that it was much easier to allow Germany to stop paying than to get her to start again, and that if Germany once stopped she would probably never resume payments.

The Lausanne Conference of 1932 was called to determine what should happen when the Hoover moratorium expired. The agreement finally reached at this conference was that Germany should deliver $714,000,000 in German Government bonds to the Bank for International Settlements as complete payment of reparations. After three years the bank should market these bonds in amounts and in such manner as it saw fit. The nations, however, agreed not to ratify this arrangement until a "satisfactory settlement" had been reached with the United States regarding the war debts. When the moratorium expired, neither war debt nor reparation payments were resumed, with the exception of the small payments due the United States by Finland, and a few so-called token payments by some of the other debtors.

The moratorium did not deal with the source of the trouble, and the depression continued to deepen.

Britain Leaves Gold.—From Vienna and Berlin, the panic spread to London. It was known that Great Britain had made extensive loans in Germany and Central Europe. As a result of the financial crisis on the Continent, many of these loans had

[1] Paul Einzig, *Behind the Scenes of International Finance* (New York: The Macmillan Co., 1932), p. v.

become frozen. At the same time, Continental countries had large amounts of money on deposit in London, which could be withdrawn upon short notice. The position of London was thus the occasion for uneasiness.

After the British return to gold in 1925, the Bank of England had continued to maintain a rather slender gold reserve, equal on the average to some $600,000,000. The funds that foreign financial institutions had on deposit in London in 1931 were well in excess of this amount. French banks were large holders of sterling balances, and began to withdraw them as did other foreign banks. London banks had nearly £100,000,000 in Germany, which were now frozen and unavailable.

Rumors were spread that London had lost heavily in the Austro-German crisis, and was in trouble. An international run on London developed, which soon assumed large proportions. Funds were withdrawn in great amounts, as fear spread that the pound was in danger of collapse. The withdrawals of deposits from London were due not only to the fear of impending disaster, but also to the necessity of meeting runs which had developed in other centers, and the desire to maintain liquidity.

In an attempt to check the run, the Bank of England and the British Government borrowed $650,000,000 from the United States and France.[2] This, however, was soon exhausted. The Bank raised its discount rate to 3½ per cent on July 23 and then to 4½ per cent a week later. In the period between April and September, the Bank paid to foreigners the equivalent of over a billion dollars. Payment was made largely out of balances which the Bank held abroad, or borrowed abroad, rather than by the exportation of gold. The exportation of gold amounted to about $160,000,000 and took place in July. On September 21, the Bank of England suspended gold payments, and the country thereby left the gold standard. The discount rate was on the same day raised to 6 per cent. The pound promptly depreciated in the foreign exchange markets.

[2] Of this amount $125,000,000 represented a credit extended to the Bank by the Federal Reserve Banks. An equal amount was loaned by the Bank of France. The remaining $400,000,000 was loaned the British Government by private lenders in the United States and France.

Great Britain's departure from the gold standard was not entirely due to the weakened position of the pound, but was also to facilitate internal economic recovery, and to relieve the country of the rigidities of the gold standard, as discussed elsewhere.

France was criticized in connection with the collapse of sterling, in that, as conditions in London became critical, France refused to lend aid until the last minute when it was too late. France, it is contended, did not desire to bring about the collapse of the pound, since this would also damage France, but wished to see London weakened and then supported by France for a price. In Great Britain it was assumed that the Bank of England and the British Government could obtain almost unlimited support from the United States. The United States, however, replied that it could lend support only in conjunction with France. The United States did not wish single-handedly to attempt to sustain the pound. Soon matters were out of bounds, and French support proved too late.

British suspension of gold payments was a tremendous shock to the rest of the world. The immediate result was to cause a considerable number of other countries also to leave gold, countries that maintained large balances in London as reserves for their currencies, which were thus dependent upon the pound. The countries which suspended gold payments following British suspension included Denmark, Norway, Sweden, Finland, India, Colombia, and Bolivia. In several other countries the governments instituted foreign exchange control to prevent depreciation. These countries included Austria, Greece, Czechoslovakia, and Italy. Several countries had left gold prior to Great Britain —Argentina in December, 1929, Australia early in 1930, and New Zealand at about the same time. In July, 1931, exchange control had been put into effect in Germany, Hungary, and Chile. Within a few weeks after British suspension less than half the world remained on gold.

The departure of Great Britain from gold with its wide repercussions, threw the world's exchange rates into disorder, and was the beginning of the extensive currency chaos and governmental measures which had profound effects upon the already disturbed economic and social conditions throughout the world.

United States Meets Gold Runs.—After England left gold, rumors were spread that the United States would be next. The position of New York was similar to that of London in that New York held very large amounts of deposits owing foreign countries. In addition, foreigners possessed large sums in bills and other short-term American credits, as well as American stocks and bonds which could be converted into cash. The United States, however, had a huge gold reserve, ample to cover all conceivable withdrawals.

On the other hand, if heavy withdrawals of gold should take place it was feared that a financial panic might result in America, since the country was in the throes of severe depression. While America held sizable amounts of short-term credits abroad, most of these were either frozen in Germany, or were in London and could not have been withdrawn except at a material loss because of the depreciation of the pound. It was then widely anticipated that the pound would ultimately return to par.

As fears regarding the dollar grew, funds were withdrawn by Europe with the result that exchange rates for dollars remained below the gold export point (from the United States). Gold began to pour out of New York, and during the six weeks' period following suspension of the gold standard by Great Britain, the United States lost $730,000,000 of gold.[3] The outflow of gold was the largest ever experienced by any country at any time during a similar period. Of the above amount of gold, $415,000,000 was not actually exported, but was earmarked for foreign central banks and remained at the Federal Reserve Bank of New York; it was, however, effectively lost to America.

At this juncture, France began to exert financial pressure upon the United States to re-enforce political negotiations which were under way. France held large balances in New York, and was the principal recipient of the gold exported. After France had re-established the gold standard in the late twenties, her capital abroad began to return to France. The Bank of France's foreign balances had thus mounted as French capital abroad was presented to the Bank for repatriation. To prevent the

[3] *Federal Reserve Bulletin,* Nov., 1931, p. 603.

franc from rising, or the rates for foreign currencies from falling, the Bank bought large amounts of foreign bills. The Bank paid francs to the French owner of the capital who wished it repatriated.[4] In this manner France came to possess large balances in America, although some of the money had been withdrawn in gold.

In October, 1931, Premier Laval[5] came to Washington to discuss with President Hoover certain problems, particularly the matter of reparations and war debts, payments on which were then suspended for one year under the Hoover moratorium. France had been taken by surprise when in June Hoover had announced this country's willingness to postpone debt payments provided reparations and other intergovernmental payments were also postponed. France, knowing that if Germany once stopped paying, it would be difficult to induce her to begin again, was very much opposed to Hoover's proposal; also irritated that France had not been consulted. Nevertheless, in view of the critical financial situation in Europe and world sentiment, France had been unable to refuse to agree. It was this situation, and what was to happen after the year's moratorium expired, that France wished to discuss with the United States.

In the middle of October, about the time that Premier Laval was leaving Paris for Washington, the Bank of France notified America that unless its balances in New York were guaranteed as to the rate of exchange, the Bank would have to withdraw them. The Bank also asked that higher interest rates be paid upon the official balances in New York, and suggested that the Federal Reserve Bank rate be raised to 4½ per cent. The proposals were made by the Deputy Governor of the Bank who had arrived in America shortly before. The United States was at

[4] It will be noted that much of the capital did not really return to France, but that the ownership was merely transferred within France, the Bank becoming the new owner and paying for it by an inflation or expansion of francs. This inflation was possible without causing a serious rise in prices because of an increased internal demand for francs, which was reflected in a slowing down of the former rapid turnover or velocity of currency, which had been due to the reduced demand and had accompanied the depreciation, and also because of the expansion of business.

[5] Executed by France after the second World War because of his collaboration with Hitler.

this time, it will be recalled, in the throes of unprecedentedly large withdrawals of capital and huge outflows of gold. The demands of France were, nonetheless, all refused. The attitude of New York was that the large French balances—about $600,-000,000—were an unstable element in the American financial picture, and that this country would be better off without them.

The United States placed no hindrances in the way of the withdrawal of funds by foreigners, and soon the outflow abated. The world was convinced that the American dollar was strong, and was not likely to follow the pound and other currencies that had left gold. Soon the tide turned back toward America, and gold was imported from abroad.

In May, 1932, as the world depression continued to become more intense, renewed withdrawals of capital from America took place, and again large amounts of gold left the country. It was feared that the dollar could not withstand the strain of this second gold run. However, Federal Reserve authorities, watching the reduction of foreign balances in America, were of the opinion that the country was in a position to pay all foreign depositors on demand, and boldly paid out gold as it was wanted. The run was again halted, and again confidence in the dollar was re-established. As a result, the flow of gold once more turned toward America. The world believed that America was the safest place in which to keep capital, and this country's gold reserves continued to mount during the last half of 1932. By the end of the year the gold reserve was larger than it had been at any time since the fall of 1931, following the departure of England from gold.

United States Abandons Gold Standard.—Meanwhile, serious banking difficulties were developing in this country. These were climaxed on March 4, 1933, when New York followed the example of numerous other states and declared a state-wide bank holiday. On March 6, the newly inaugurated President Roosevelt proclaimed a national bank holiday, and suspended all redemption in gold. On March 10 he forbade the exportation of gold from the country except under license. Gold reserves at

that time were larger than they had been for over a year and a half.

The dollar remained fairly stable in the exchange market between March 6 and April 19. On April 20 the President prohibited the export of gold except as authorized by the Treasury Department with the approval of the President, with a few exceptions. This indicated that the dollar was not to be maintained at par, and it depreciated rapidly in the exchange market. By the end of the year the dollar had declined greatly in terms of gold and gold standard currencies. The French franc rose from about 3.9 cents in January, 1933, to about 6.2 cents in December. Other gold currencies also rose in the same proportion. The depreciated pound during the same period rose from about $3.35 in January, to $3.43 in March, and to $5.12 in December, 1933, thus being above the former par. In November, 1932, the pound had declined to a low of about $3.14.

In an attempt to raise the commodity price level and thereby facilitate economic recovery, President Roosevelt, on October 22, 1933, announced in a radio address that the government would begin buying gold.[6] The gold-buying program was accordingly begun on October 25. The Reconstruction Finance Corporation, acting for the government, agreed to buy all foreign or newly mined American gold at prices determined from time to time. On October 24, the day before gold-buying operations were begun, the price of gold in the London market was the equivalent of $29.74 an ounce, compared with the United States mint price of $20.67.[7] In other words, $29.74 in American money was required to purchase enough British pounds to buy one ounce of gold in London.

The initial gold-buying price on October 25, was $31.36 per ounce. During the first week of the program, new prices were announced each day: $31.54 on October 26, $31.76 on the 27th,

[6] The so-called Thomas amendments to the Agricultural Adjustment Act of May, 1933, gave the President broad powers over the currency, including that of reducing the gold content of the dollar up to a maximum of 50 per cent.

[7] The world gold market centered in London. In going off the gold standard, England did not place an embargo on exports of gold, but merely suspended redemption of its currency in gold. Hence the London gold market was not destroyed.

$31.82 on the 28th, and so on. Thereafter, prices were raised at irregular intervals until the price was $34.45 on January 16, 1934. On January 31, 1934, the dollar was officially devalued, the price of gold being fixed at $35 an ounce. The new dollar thus represented 13.71+ grains of fine gold, or 59.06 per cent as much as the old dollar of 23.22 grains. Foreign exchange rates promptly adjusted to this level. The dollar has since been kept firmly at this level in terms of gold.

After devaluation the United States received large quantities of gold. This influx was due partly to the high price paid in America, but later was the result principally of the heavy flow of capital to America. Capital came to seek safety from the economic and political troubles of Europe, and also to take advantage of recovery and the attractive investment possibilities in the American market.

The Gold-Bloc Countries.—After the United States abandoned gold, the European countries that remained tied to gold, notably France, Italy, Switzerland, Belgium, and Holland, became known as the gold-bloc countries. These countries soon found their position extremely difficult. The currencies of the gold-bloc countries were at a premium throughout most of the world, so that their goods were expensive to foreigners. For example, the French franc was high in price abroad, in relation to its former level and in relation to its purchasing power within France. French goods, therefore, became so expensive that France found difficulty in selling to the rest of the world. Costs in France thus had to be reduced. The process of adjusting prices downward was depressing, and the cause of social and political troubles.

The gold-bloc countries, subjected to severe deflationary pressure and declining price levels, nevertheless, vigorously declared their intention of remaining upon gold. Even though their currencies were overvalued in terms of most of those of the world, and capital was leaving the countries, seeking safety abroad, the possibility of devaluation was repudiated.

One of the reasons that these countries were so determined to stay upon gold at the established level was that the public had

fresh memories of the previous currency troubles, inflation and devaluation. To them devaluation meant a destruction of their savings and other values. The situation was, of course, not parallel, inasmuch as the earlier devaluation was merely legal recognition of depreciation which had already taken place. A further devaluation of the gold unit now, to bring exchange rates into line with internal values, did not necessarily mean subsequent internal depreciation or inflation, although it might increase the cost of certain imported goods. It meant, instead, an effort to prevent further deflation and fall in prices. In most of the gold-bloc countries, however, devaluation was so unpopular that it was a political impossibility, at least for the time being.

Conditions became more and more critical, and the reserves behind these currencies were subjected to increasing pressure as foreign capital was withdrawn or as domestic capital was transferred abroad. The flight of capital went steadily forward in spite of government controls aimed to prevent it. Internal conditions, both economic and social, were disturbed as prosperity in these countries failed to return. It became clear that eventually revaluation must take place.

One by one the gold-bloc countries were finally forced to revalue their currencies. Belgium, in March, 1935, was the first to leave the ranks, when the belga was reduced from .209211 grams of fine gold (established October 25, 1926) to .150632 grams. Prior to devaluation the belga was worth about 23.3 cents in New York, whereas afterwards it fell to about 16.9 cents, in line with the new gold content.

France Devalues.—From August 7, to September 25, 1936, the Bank of France lost $320,000,000 of gold, principally to the United States and England. On September 26, the gold standard was virtually suspended in France as a result of emergency measures. A special session of Parliament was summoned and, by law of October 1, suspended the gold standard law of June 25, 1928. This earlier law had fixed the content of the franc at 65.5 milligrams of gold .900 fine. The new law authorized the government to fix the gold content of the franc at between approximately 65.6 and 74.8 per cent of the previous amount.

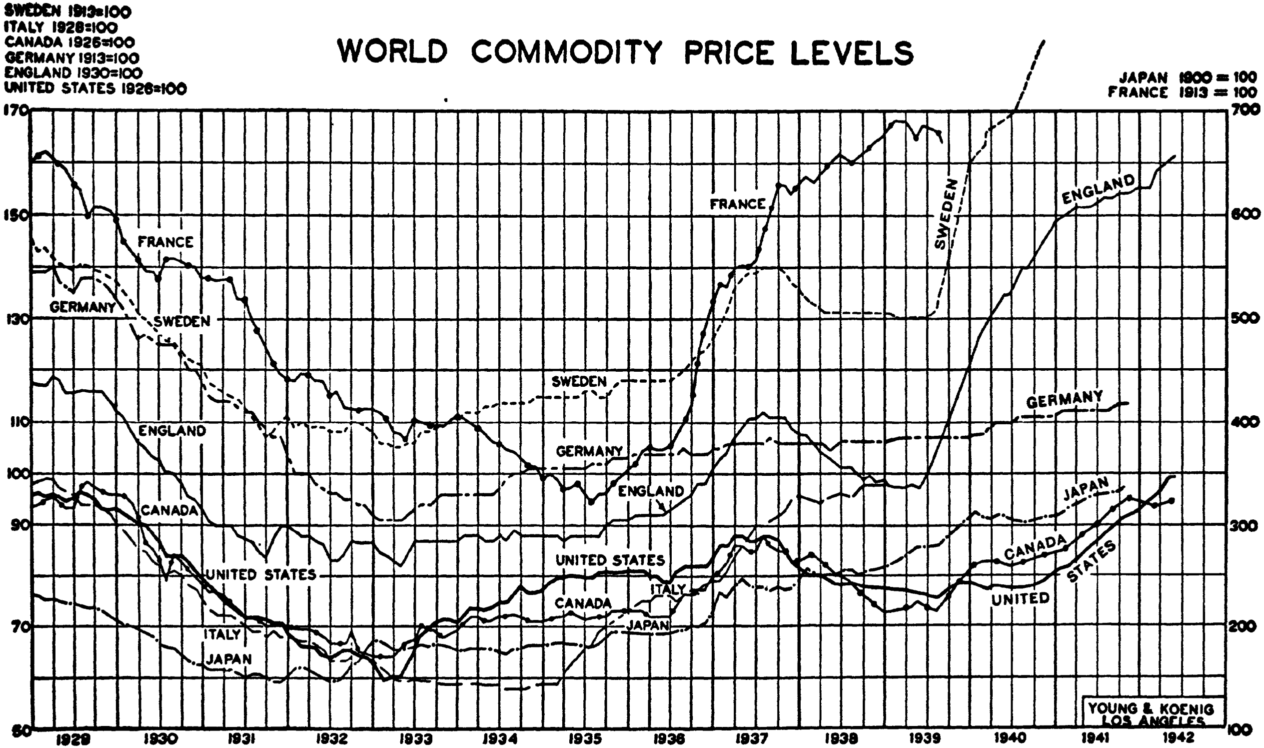


FIG. 10.—World Commodity Price Levels, 1929-42

Prior to devaluation, exchange rates in New York were about 6.6 cents per franc. The franc, however, was not worth this much on the basis of its internal purchasing power. After devaluation the rates declined to about 4.6 cents, which was in closer harmony with the internal value of the franc from the standpoint of equilibrium in French international accounts. Soon after devaluation prices rose sharply as can be seen in Figure 10. This rise accompanied economic recovery in France. As the French gold reserve was written up in value in accordance with the new law, a portion of the profit was set aside, as in the case of the United States, to establish a stabilization fund for the purpose of controlling exchange rates.

A significant aspect of the French devaluation was the accompanying Tripartite Currency Agreement between France, Great Britain, and the United States, announced September 25, 1936. According to this so-called "gentleman's agreement," these countries agreed to cooperate in the stabilization of their currencies. Without this accomplishment to present to the French public, it is improbable that the French Government would have been able to have arranged the greatly needed devaluation without serious internal difficulties. This Tripartite Agreement, or declaration, is discussed in Chapter 38.

Devaluation did not mark the end of France's troubles. France struggled with a comprehensive social reform program, as well as with international difficulties. This situation created nervousness and caused capital to leave France. Since confidence was not restored, French capital abroad did not return as was the case following the former stabilization. The return of capital before had helped to strengthen the franc. The budget continued unbalanced, and an excess of imports put pressure upon exchange rates.

During the spring of 1937 the franc was again under heavy pressure, and between June 1 and 28 gold losses of the Stabilization Fund and of the Bank of France amounted to about $350,000,000. On June 30, Parliament gave the government decree powers, and the same day a decree was issued, effective July 1, removing the previous legal limits to exchange fluctuations as

established by the law of October, 1936. The franc was then allowed to sag, and in the latter part of 1937 declined to about 3.3 cents. The Tripartite Currency Declaration, however, continued in force, and communications from America and Great Britain to the French Minister of Finance reaffirmed the arrangement. Late in 1937 the position of the franc strengthened, and gold flowed from America to France, but early in 1938 another crisis developed and the franc fell to a little over 3 cents.

On September 27, 1936, immediately after suspension of the gold standard by France, Holland left gold, and the next day Switzerland did the same. Both these countries devalued their currencies and established stabilization funds. Together with Belgium, these countries joined the currency accord between France, Great Britain, and the United States.

The gold-bloc countries were victims of revaluations in other countries, which thereby left the currencies of the gold-bloc countries out of step with the rest of the world. Exchange rates were gradually and painfully adjusted by means of the various devaluations, to levels where trade in both directions could take place profitably on a basis of reasonable balance. After the devaluations had been completed, exchange rates and price level relationships between the different countries were not far from where they had been prior to the currency disorders, in spite of the violent gyrations in exchange rates and the drastic declines in commodity prices that had taken place in the meantime. Figure 9 shows the declines in price levels of the leading countries from 1929 to 1932, and the recovery of 1933-37. The French price level did not reach its low point until 1935, and then rose sharply, particularly after devaluation in 1936.

The Approach of War.—The flow of world trade increased steadily from 1933 on, as can be seen in Figure 11. As trade improved and internal commodity price levels became more stable (or less unstable), exchange fluctuations became less severe. At the beginning of 1938, trade turned downward, reflecting the economic troubles of that period, but the decline was short-lived and toward the end of the year trade was again expanding. Much of this trade represented materials, particu-

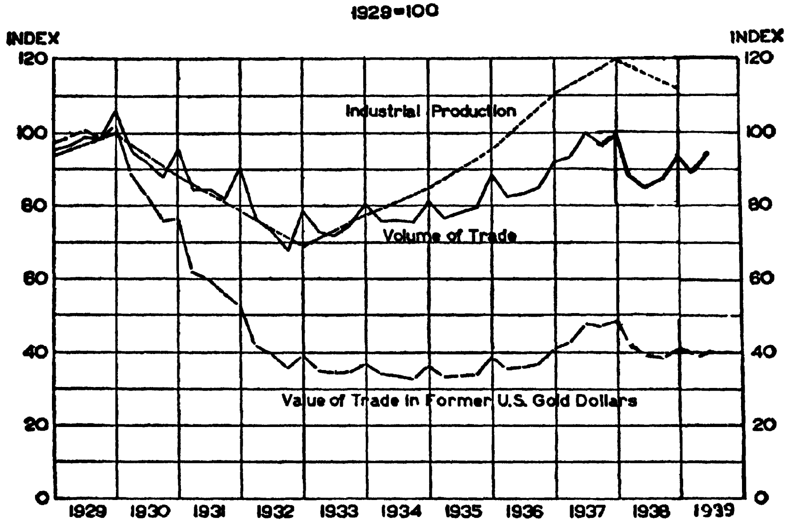


FIG. 11.—World Production and Trade from 1929 to 1939.

(This chart is based on League of Nations figures.)

larly raw materials, needed for armaments as Europe prepared for war.

When war began in 1939, world trade was still far below the 1929 level. The many restrictions on the movement of goods had prevented any real expansion of foreign trade. The trend toward economic nationalism, mounting trade barriers, and other repressive regulations held back any broad commercial expansion. High tariffs in the case of most countries were overshadowed by new devices such as quotas, exchange control, and bilateral clearing agreements. The international trading mechanism became increasingly clogged as a result of the governmental measures and the deteriorating political situation.

International lending during the nineteen twenties had helped to keep world trade and finance in a state of balance, but a somewhat precarious balance in that it was dependent to a large extent on an item subject to sudden change. Foreign lending collapsed almost completely with the depression. The numerous defaults, currency depreciations, and financial difficulties which occurred in practically every country interfered with the exten-

sion of credit internationally, and made impossible the public flotation of new loans in the world's financial centers. The investing public was in no mood to buy foreign securities, particularly in view of the threatening political situation. A result was that the maladjustments and disturbed conditions were intensified.

In April, 1937, Paul van Zeeland, then Premier of Belgium, was invited by the governments of Great Britain and France to report on "the possibility of obtaining a general reduction in the obstacles to international trade." [8] After visiting various countries and making extensive studies, Mr. van Zeeland presented his report in January, 1938. He recognized the serious difficulties in the way of bringing order out of the existing disorderly state of affairs. In the report he urged nations to refrain from further increases in quotas and exchange controls which, he felt, had become a greater obstruction to trade than tariffs. He expressed the hope that countries would continue to make bilateral tariff agreements to free trade from prevailing restrictions.

In regard to currency and financial problems he felt that currency stabilization at fixed gold parities would have to await great equilibrium in both the economic and financial spheres; he favored the restoration of the gold standard, but upon an altered basis. The necessity for collaboration among the various powers in economic matters was recognized and Mr. van Zeeland urged that representatives of Great Britain, United States, France, Germany, and Italy confer as to what could be accomplished in this direction. He was aware, however, of the serious political difficulties in the way of the program proposed.

Capital came to America during these years seeking to escape the disturbed conditions and the impending war. This movement took place in spite of restrictions on the transfer of capital which existed in most countries. Great Britain held to a free market, fluctuations in the pound being moderated through operations of the Exchange Equalization Account; but on the Continent of Europe and in other parts of the world where

[8] *The Economist*, London, Jan. 29, 1938.

exchange control existed, black market operations were extensive. One of the methods by which capital found its way to the United States was through the invoicing of exports to this country at low values, the American importer then depositing an additional sum in the United States as directed by the exporter.

Deposit balances and other short-term assets held in the United States for foreign account increased greatly during the years immediately preceding the war, and also after the war commenced, especially after the collapse of France in 1940. Gold poured into the United States at an unprecedented rate and built up this country's gold stock to $16,646,000,000 in August, 1939 and to approximately $22,800,000,000 at the time of Pearl Harbor in December, 1941. After this date the gold stock declined gradually, partly as a result of earmarking operations.

Chapter 41

INTERNATIONAL FINANCE SINCE 1939

The Second World War.—Upon the outbreak of war in the fall of 1939, emergency financial measures were adopted by most countries, neutrals as well as belligerents. In Great Britain special measures were taken prior to actual hostilities, and on August 24, 1939, there was enacted the Emergency Powers Bill. This gave the government sweeping powers over all phases of the country's economic life. In France full powers had been given the government in the spring of 1939, so that no new authority was required. The German economy was already largely on a war footing, but additional measures were taken, such as increasing taxes and preventing profiteering.

On August 25, 1939 the Exchange Equalization Account ceased to support the pound, which depreciated rapidly. Rates for dollars had previously been maintained at approximately \$4.68. After the war began the official rates were fixed at \$4.04 buying, and \$4.02 selling, but rates in financial centers outside Great Britain continued to decline. Regulations were gradually tightened and by the fall of 1940 the effective rates for most sterling transactions everywhere were \$4.02½-\$4.03½. The Bank of England raised its discount rate from 2 per cent to 4 per cent on August 24, but in September lowered it to 3 per cent, and in October back to 2 per cent. John Maynard Keynes urged that the Bank maintain a low rate.

The British Treasury on August 24, 1939, ordered all owners of foreign securities to make a return of their holdings to the Bank of England within thirty days. This mobilization of foreign assets was to provide resources with which to purchase from abroad necessary materials. British foreign assets before the war are estimated by the Bank of England to have amounted

to about £3,545 million. In 1948 they are estimated by the Bank to have amounted to only £1,960 million. From 1938 to 1948 the liquidation of foreign investments yielded £1,244 million in cash, either from voluntary or forced liquidation. The total gold and dollar assets at the beginning of the war are estimated to have amounted to $4,483,000,000.[1]

The Currency (Defense) Bill was passed on September 1, and provided that the resources of the Exchange Equalization Account could be utilized for war purposes. A few days later the Chancellor of the Exchequer announced that 280,000,000 pounds in gold would be transferred from the Bank of England to the Exchange Account, thereby increasing its available resources. The demand for dollars was great, and after the first eighteen months of war these resources were practically exhausted. Great Britain thereafter had to meet the demand for foreign exchange from overseas assets and from reduced current exports. As a consequence, British foreign investments declined greatly as noted.

Arrangements were made with sterling area countries to turn over to Great Britain for pounds the dollar exchange received from their exports to dollar countries. Imports from the United States were paid for in dollars, but sterling area countries received balances in pounds. This subject is discussed in Chapter 23. Great Britain's critical need for dollars was relieved by the passage by the United States of the Lend-Lease Act in March, 1941.

Commodity prices in Great Britain rose steadily after war commenced. From 98 in August, 1939, the Board of Trade index of wholesale prices rose to nearly 150 by the end of 1940. The rise from that point on was more gradual, due especially to more rigid price control measures, and the index for the year 1945 was 155. After the war, prices rose more rapidly, particularly after the beginning of the Korean War. The figure for May, 1951, was 294. Price control was instituted in Great Britain prior to the second World War, but no broad price

[1] W. Walton Butterworth, "Britain's Changing Position as a Creditor Country," *Foreign Commerce Weekly,* U. S. Department of Commerce, Oct. 18, 1941.

control law was adopted until November, 1939, when the Prices of Goods Act was enacted. This law was not adequate and was therefore supplemented by the Goods and Services Act of July, 1941.[2] The rise in prices reflected the course of inflation. The money supply, currency and deposits, increased from £1.79 billion in 1939, to £4.42 billion in 1945 and to £5.06 billion in May, 1951. Provisions regarding the fiduciary circulation were revised so as to make possible the expansion of note circulation.

Inflation in France proceeded much farther than in England. The circulation of the Bank of France increased from 123,000,000,000 francs in July, 1939, to about 160 billions when the country was overrun by Germany, and to about 577 billions at the end of 1945. After the war the total money supply (including deposits) rose from 1,013 billion francs at the end of 1945 to 3,189 billion in March, 1951. Wholesale prices in France rose from 118 in 1939 to 421 for 1945, and to 3,040 in May, 1951. Due to the official controls, price indices have less significance as a guide to the extent of inflation in the economy. The greater the degree of price control the less meaningful are price indices.

When Germany invaded Denmark and Norway in April, 1940, the United States froze the assets owned by these countries in the United States. The purpose was to prevent the American funds and property of these countries from being used by Germany, and to protect such assets for their owners. Freezing was extended to other countries as they were conquered by Germany. In June, 1941, the United States finally froze German and Italian assets, the reason in this instance being to prevent their use for purposes inimical to the United States. In anticipation of such freezing, large sums were transferred by these countries to Latin America, especially to Argentina. Japanese assets were frozen July 25, 1941, after which date all transactions with Japan were subjected to licensing. Inasmuch as no licenses were granted, trade with Japan came practically to a halt.

[2] Cf. Thomas R. Wilson, "British Price Control Legislation," *Foreign Commerce Weekly,* U. S. Department of Commerce, Sept. 27, 1941.

In June, 1941, the United States banned all trade and financial dealings with nationals of states whose assets were blocked, and with firms in which such nationals had a substantial interest. The ban threatened to halt a large portion of the foreign trade of the United States, especially in Latin America where Axis nationals had extensive interests. The difficulty was because American traders could not be sure whether Axis nationals were interested or not in the foreign companies with which Americans were carrying on transactions. Violation of the prohibition carried a fine of $10,000 and 10 years in prison. Accordingly in July, 1941, the President issued the "Proclaimed List of Certain Blocked Nationals," which became known as the black list. A general license was issued permitting trade with persons or firms not on this list. Firms suspected of being cloaks for Axis transactions were also included in the ban. Japanese firms were not added to the list until after the attack on Pearl Harbor, December 7, 1941. The list was expanded from time to time, and also some names were removed after Axis interests were eliminated or undesirable practices discontinued.

Export control was instituted by the United States in July, 1940, and by April, 1941, nearly half of the exports of this country were subject to licensing. Licenses were first required for arms, ammunition, certain machine tools, chemicals, and raw materials. After the United States entered the war all exports were placed under license. Other war-time financial measures such as lend-lease and the "dollar pool" of the sterling area have already been discussed.

Financing Reconstruction.—The end of the war in 1945 found the European countries with a major portion of their productive facilities, transportation, public utilities, ports, and cities destroyed, and with stocks of food and other necessary supplies exhausted or low. Large sums of money were needed to pay for the urgently needed imports.

The European countries had at the end of the war substantial holdings of dollars and gold, which constituted in large part their monetary reserves. These funds were drawn down during

the next few years to help pay for essential imports. The total gold and short-term dollar holdings of all foreign countries as of June 30, 1945, amounted to $19.899 billion. By September 30, 1949, these were reduced to $14.660 billion, a decline of over $5 billion. After this date, however, these holdings increased, as discussed below. The accompanying table shows the movement in the gold and dollar holdings of foreign countries.

TABLE 17

ESTIMATED FOREIGN GOLD AND SHORT-TERM DOLLAR BALANCES *

(In millions of dollars)

Area	June 30, 1945	December 31,				March 31, 1951
		1947	1948	1949	1950 †	
Total, All Areas	19,899	15,157	14,913	15,228	18,764	19,553
Total, Europe	11,235	8,555	8,446	8,490	10,508	10,970
ERP Participants ‡	10,206	7,552	7,638	7,776	9,849	10,342
Other Europe §	1,029	1,003	808	720	659	628
Latin America	3,625	2,877	2,744	3,055	3,454	3,727
Asia and Oceania ‖	2,462	2,081	2,187	2,038	2,371	2,453
Canada	1,613	720	1,225	1,365	1,988	1,940
All other	964	924	311	274	443	463

* Excludes holdings of the International Monetary Fund, the International Bank, and other international organizations; also excludes U.S.S.R. gold holdings. Now includes holdings of U. S. Government securities with original maturity of more than one year but not more than twenty months.

† Includes for the first time certain short-term dollar balances which, though existing at lower levels in previous years, were not reported by U. S. banking institutions until August, 1950. These balances account for only a small portion of the indicated increase in holdings.

‡ Including dependencies.

§ Includes gold held by Tripartite Commission for the Restitution of Monetary Gold.

‖ Indonesian holdings are included in Asia and Oceania for all years shown in this table.

(Source: Principally Nationally Advisory Council on International Monetary and Financial Problems. Report for Period April 1, 1950—September 30, 1950.)

Europe's reduced earnings from current exports of goods and services during these years, together with their holdings of gold and dollars, were far from adequate to pay for the large imports needed to restore productive facilities and to meet current consumption needs. It was recognized during the war that Europe would need substantial help in order to finance the extensive reconstruction that would be required. It was also realized that

immediate relief needs would be great. Funds for relief purposes were provided through the United Nations Relief and Rehabilitation Administration (UNRRA), to which the United States Government contributed $2.6 billion. This money was made available on a grant basis and was spent principally during 1946 and 1947. Postwar lend-lease grants were also of substantial assistance to reconstruction. Lend-lease aid that was provided after VJ Day amounted to $2.5 billion. The United States in 1946 extended a loan of $3.750 billion to the United Kingdom, to help meet balance of payments deficits and thereby to facilitate restoration of sterling convertibility. The proceeds from this loan were entirely exhausted by the end of 1948.[3] Civilian supplies provided by the United States Government for the needs of occupied areas (GARIOA)[4] averaged about one billion dollars a year during the few years after the war.

Other aid was extended by the United States in the form of surplus property sold on credit, Export-Import Bank loans, and particularly after the middle of 1948, by the Economic Cooperation Administration. In view of the fact that the cost of reconstruction was greater than had been anticipated, and that Europe was running out of dollar resources with urgent needs remaining, the United States in 1948 created the Economic Cooperation Administration (ECA) to provide funds to help restore Europe's productive capacity, and to give the people hope for the future and thereby to help to check the spread of communism. These funds were made available by the United States on both a loan and grant basis, but largely on a grant basis, inasmuch as Europe's capacity to repay loans was not large. ECA allotments by the middle of 1951 totaled approximately $12 billion.[5]

The International Bank for Reconstruction and Development was organized in 1946, as noted above, one of its main purposes being to help to finance reconstruction. In 1947 the Bank began to make loans, the first loan being to France in the amount of $250 million. Other reconstruction loans were made to Belgium, Denmark, Finland, Luxembourg, the Netherlands

[3] See Chapter 23.

[4] Government and Relief in Occupied Areas.

[5] See Chapter 34 for a discussion of the ERP program.

and Yugoslavia. These loans made an important contribution to the meeting of Europe's reconstruction needs.

Private investment was expected to help supply dollars to Europe, but the amounts from this source were relatively small. Donations from private sources, however, were large and aided greatly during the difficult post-war years.

The "Dollar Shortage" and Postwar Disequilibrium.— During the war the large exports from the United States for war purposes had been financed by lend-lease aid, so that the European and other countries were not bothered by balance of payment problems due to these exports. Lend-lease aid was terminated in the latter part of 1945, although certain lend-lease deliveries were continued in order to fulfill commitments. After the termination of lend-lease, and as a result of the great expansion in United States exports to meet postwar foreign needs, the United States developed a large export surplus. In 1947 United States exports of goods and services amounted to $19.741 billion, compared with imports of goods and services of $8.463 billion. This United States surplus of $11.278 billion meant that other countries were experiencing deficits. The ability of the European countries to export was seriously curtailed as a result of the extensive war devastation. The means by which the deficits of foreign countries were met during this period has already been discussed. Figure 12 shows graphically the extent of the accumulated deficits for the five years from the middle of 1945 to the middle of 1950.

The strong demand of foreign countries for United States goods resulted in a scarcity of dollars at the prevailing fixed rates of exchange. In order to prevent drastic exchange depreciation because of the demand for dollars, as was the case after the first World War, practically all countries continued exchange restrictions and maintained a fixed rate, or in some cases two or more rates of exchange. The terms "dollar shortage" and "dollar gap" were employed to describe the condition of an inadequate supply of dollars at the established rates of exchange.

Many of the rates in force during these years were unrealistic, and seriously overvalued the currencies in terms of the

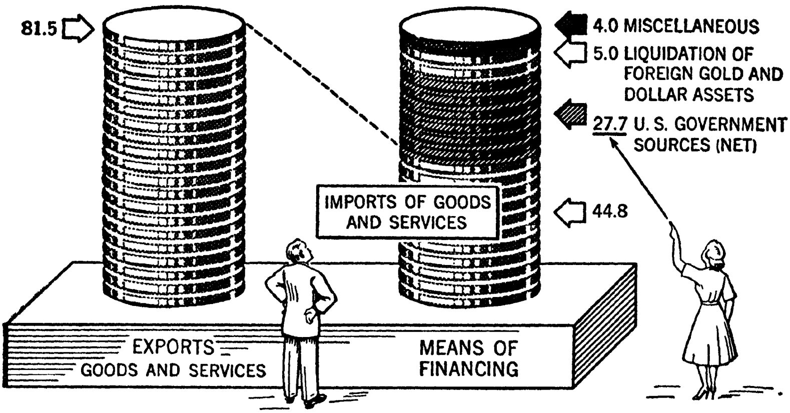


FIG. 12.—United States Balance of Payments for Five-Year Period, July 1, 1945, to June 30, 1950 (in billions of dollars)

(Source: National Advisory Council on International Monetary and Financial Problems. Report for the Period April 1-Sept. 30, 1950.)

United States dollar from the standpoint of a rate which would promote equilibrium between international payments and receipts. When the International Monetary Fund in December, 1946, accepted the par values filed with it at that time by its members, the Fund recognized the inappropriateness of many of these rates and that adjustments would later be necessary. At that time international trade was so disrupted as a result of the war, and inflation was proceeding at such a pace that it was difficult to determine the appropriate relationship of the different currencies to each other. It was considered premature to attempt to establish a rate structure which would promote balanced conditions and give promise of permanence.

Considerable discussion took place as to whether rate adjustments should be made from time to time during this period of dislocated trade, especially in cases where a currency was clearly out of line, and whether a more realistic rate would facilitate recovery, or on the other hand whether adjustments should be deferred until more stable conditions had been restored. Devaluation was politically unpopular, and for this and other reasons governments were reluctant to adjust their ex-

change rates. They feared that increased costs for imported goods would raise the cost of living, already a serious problem, and that exports would not be materially stimulated by devaluation, inasmuch as the country was, it was said, already exporting as much as it could. The idea was advanced that exports and imports were inelastic and that only a drastic rate adjustment would have much effect in promoting equilibrium, also that devaluation would worsen the terms of trade. Consequently, a variety of import controls were imposed and fixed rates maintained through exchange restrictions. Enforcement, however, was difficult and black markets were extensive. The effective rate was thus frequently not that shown officially.

Price levels continued to rise in most countries, and added to the maladjustments, but price index numbers did not reflect fully the extent of the inflation of the money supply because of price controls. Figure 13 shows price movements in the United Kingdom and certain other countries.

A number of adjustments in exchange rates were made during the early postwar years, but usually these were not adequate to bring about conditions which would permit restoration of a free market (not always desired apart from balance of payments and reserve considerations), and were in the nature of an elimination of a portion only of the overvaluation. Some of these adjustments involved a free exchange market for certain types of transactions as noted in Chapter 22.

France in 1948 established a system of multiple rates in place of the rate of 119.3 francs to the dollar, which had been in force since shortly after the end of the war and which had become unrealistic in view of the sharp rise of prices within France. Wholesale prices in France rose from an average of 421 for 1945 to 1,920 for 1948. The new exchange system involved the establishment of an official parity of 214.392 francs per dollar, such rate to be applied to certain essential imports, a free market for nontrade transactions (and consequently a free market rate for such transactions), and a rate for commercial transactions which was the daily average of the free rate and the official parity. For example, these three rates in 1949 were 214.71, 325.15 and 269.93, respectively. In September, 1949,

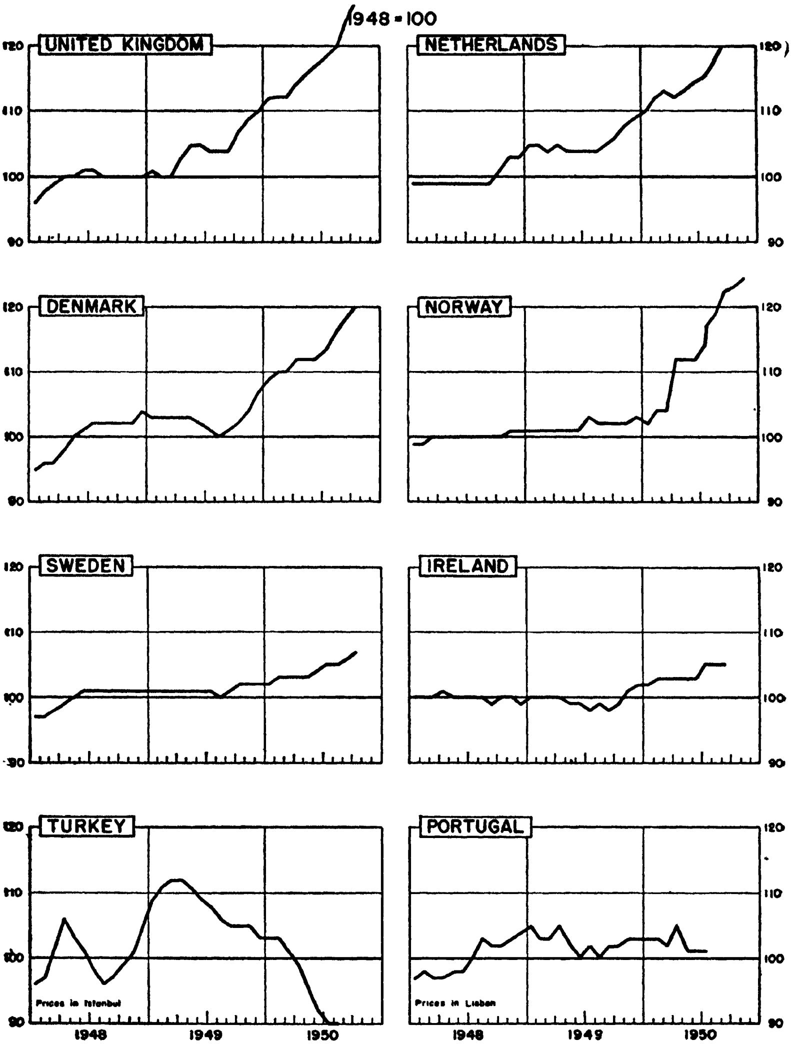


FIG. 13.—Wholesale Price Indexes

(Source: Division of Statistics and Reports, Economic Cooperation Administration.)

these rates were abolished and a single rate of about 349 was adopted.

As recovery throughout Europe progressed, it became increasingly apparent that a general revision of the exchange rate structure was necessary in the interest of facilitating an expansion of trade, both intra-European trade as well as trade of Europe with other countries, and of creating conditions which would make possible a relaxation of the many restrictions which were imposed on trade for balance of payments reasons.

Production in most countries had by 1949 made good recovery and had surpassed prewar levels. Figures 14 and 15 show the recovery in industrial production for the world and for certain individual countries, and its level in comparison to that in 1937. Further progress, however, was being impeded by the serious payments problems, and the burdensome restrictions on trade imposed because of these payments problems. The source of much of the trouble was generally recognized to be the inappropriate exchange rates then prevailing. Most of the European currencies were overvalued in terms of the dollar, and also in some cases in terms of each other. The export prices of Europe's goods were high in comparison with dollar prices of similar goods. It became increasingly difficult for the European countries to export to the dollar area. They also found difficulty in competing with dollar goods in their home market as well as in other countries.

The inconvertible European currencies, which included all except the Swiss franc, were known as soft currencies, whereas the United States dollar and other gold convertible currencies were known as hard currencies. Countries were reluctant to accept soft currencies since these could not be used to pay for imports from the dollar or hard currency area, nor could they always be converted into other soft currencies. Bilateral payments arrangements were made in order to finance trade as discussed in Chapter 21.

The decline in the exports of European countries to the United States and other dollar convertible countries, and the reduction in gold and dollar reserves, particularly the reduction in the reserves of Great Britain, made it clear that exchange

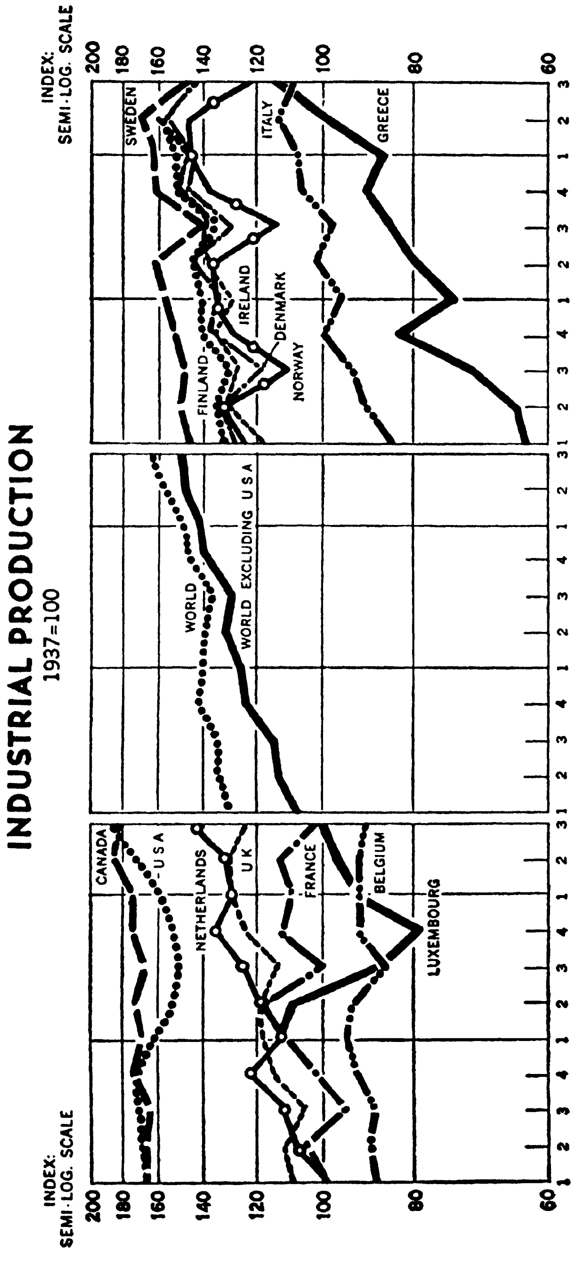


FIG. 14.—Industrial Production, World and Certain Countries, 1948-50

(Source: Division of Statistics and Reports, Economic Cooperation Administration.)

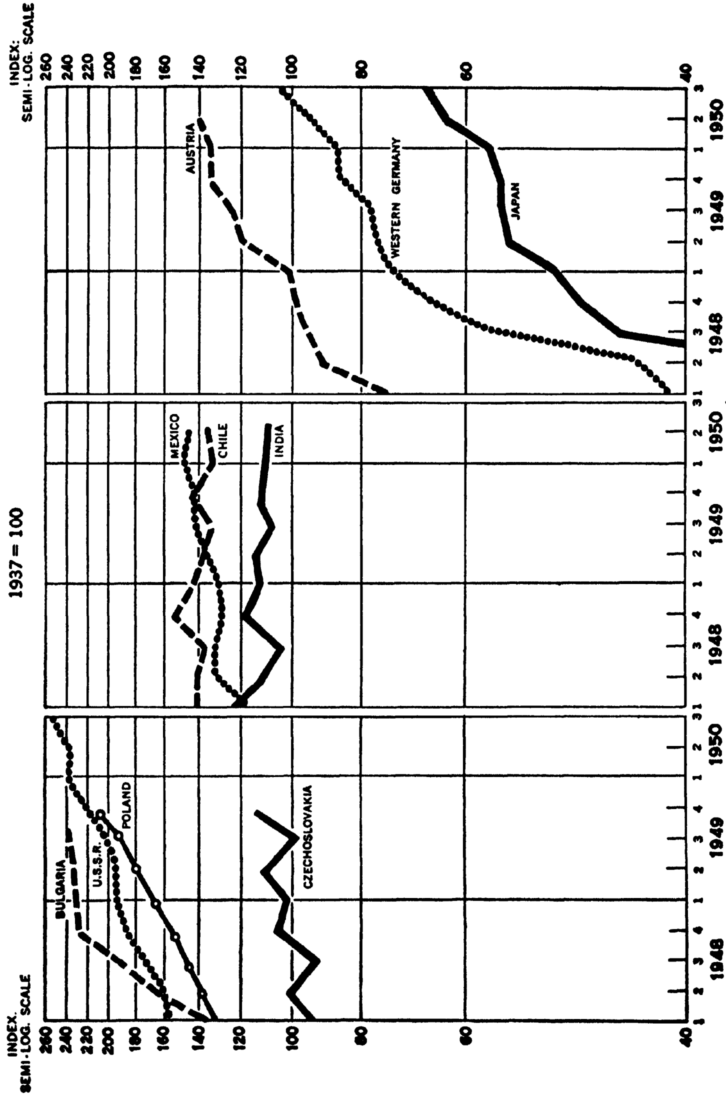


FIG. 15.—Industrial Production, Selected Countries, 1948-50

(Source: Division of Statistics and Reports, Economic Cooperation Administration.)

adjustments could not long be postponed. From the first of April, 1949, to the middle of September, 1949, British (i.e., sterling area) reserves declined by over $500 million, greatly weakening the British reserve position.

British imports from the United States in 1947 constituted one-third of total imports compared with 23 per cent in 1938. In 1948 the proportions were about the same even after severe restrictions had been imposed on dollar imports. The total volume of British imports in 1947 was only 76 per cent of that of 1938. On the export side the proportion of United States imports received from Great Britain had declined to 4 per cent compared with 6 per cent in 1938. A mild recession in the United States in 1949, contributed to the reduction of British and sterling area exports to the United States and to their lack of dollars. British exports in 1948 had increased to 136 per cent of those of 1938.

A contributing factor to the change in the trade of the United States with other countries was the tendency of the United States to become more self-sufficient with respect to certain raw materials and also certain manufactured articles. The national income in the United States increased more rapidly than the supply of dollars made available to the world through United States imports. A similar situation prevailed with respect to Canada.

Confidence in the future of sterling became seriously weakened during 1949, and foreign purchases in the United Kingdom were withheld in anticipation of devaluation. Exporters to the United Kingdom at the same time hastened deliveries and sought to obtain payment quickly. A flight from sterling was under way, insofar as this was possible under the various controls. Reserves declined by about 20 per cent in the eleven weeks prior to September 18, 1949.

Devaluations of 1949.—The International Monetary Fund in the middle of September, 1949, conferred with British officials as well as those of several other countries, and on September 18 devaluations were announced for the pound and several other countries. Within a period of a few days some twenty-five countries had devalued their currencies. The number soon in-

creased to twenty-nine.[6] The pound was reduced from its previous value of $4.03 to $2.80, which was more of a reduction than had been anticipated. Some countries felt that this reduction would give an unfair competitive advantage to British exports. The countries which devalued in September, 1949, accounted for about 65 per cent of total world trade on the basis of 1948 world imports. Most of the devaluations were about 30.5 per cent in relation to the United States dollar.

After the devaluations the pattern of trade shifted considerably in the direction of greater balance. Exports to the United States and other dollar area countries increased, whereas imports from the United States and other dollar countries declined. The International Monetary Fund said, as noted in Chapter 24, "These shifts accordingly were largely in favor of the countries which devalued most and against those which did not devalue or devalued least." [7]

The shift in trade was not due entirely to devaluation, but devaluation was no doubt an important factor in the improvement. The extent to which devaluation was a factor in the improvement has been the subject of some debate. The rise in agricultural and industrial production in Western Europe and the Far East helped to relieve the unbalanced condition of trade by making countries less dependent upon imports from

[6] These countries and the dates of devaluation were as follows:

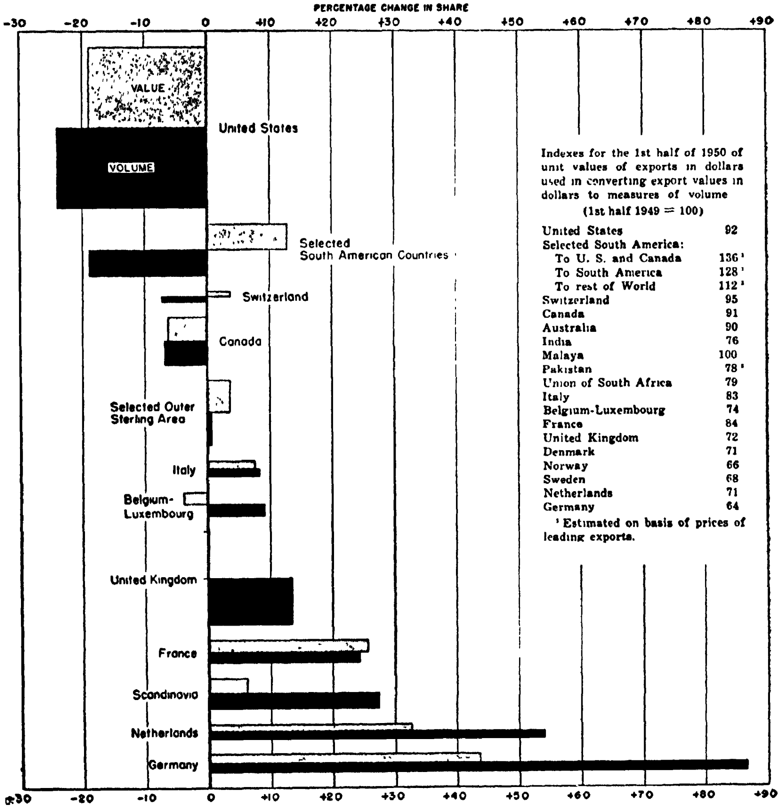
Country	Date of Announcement	Country	Date of Announcement
Afghanistan	Oct. 19. 1949	India	Sept. 18, 1949
Australia	Sept. 18, 1949	Iraq	Sept. 20, 1949
Belgium	Sept. 21, 1949	Ireland	Sept. 18, 1949
Bolivia	Apr. 24, 1950	Israel	Sept. 19, 1949
Burma	Sept. 18, 1949	Jordan	Sept. 22, 1949
Canada	Sept. 19, 1949	Luxembourg	Sept. 23, 1949
Ceylon	Sept. 18, 1949	Netherlands	Sept. 20, 1949
Denmark	Sept. 18, 1949	New Zealand	Sept. 18, 1949
Egypt	Sept. 19, 1949	Norway	Sept. 18, 1949
Finland	Sept. 19, 1949	Portugal	Sept. 19, 1949
France	Sept. 20, 1949	Sweden	Sept. 18, 1949
Germany, Western	Sept. 29, 1949	Thailand	Sept. 27, 1949
Greece	Sept. 22, 1949	Union of South Africa	Sept. 18, 1949
Iceland	Sept. 20, 1949	U.S.S.R.	Feb. 28, 1950
	Mar. 20, 1950	United Kingdom	Sept. 18, 1949

Cf. International Monetary Fund, Annual Report for 1950.

[7] Cf. International Monetary Fund Press Release No. 142, August 31, 1950.

the United States. The revival of inter-European trade was thus also apparently an important factor in the improvement.

Figure 16 prepared by the International Monetary Fund shows the situation graphically. The width of the bars in the chart represents the share of the specified exporter in the total imports of the countries represented. The areas of the bars thus indicate the total amounts of the shifts in trade. The chart



* No change in United Kingdom's value share.

FIG. 16.—Changes in Principal Exporters' Shares of World Markets After Devaluations

First half of 1950 compared with first half of 1949. Percentage change from first half of 1949 to first half of 1950. Width of each bar indicates relative importance of the exporter in the world markets represented.

(Source: *International Financial Statistics*, Vol. III, No. 12, December, 1950, International Monetary Fund.)

shows that the devaluing countries increased their exports to hard currency countries, and reduced their imports from such countries.

It was feared in some quarters that as a result of devaluation, the increased costs of imported goods in the devaluing countries would result in substantial increases in the cost of living. While certain imported items became more costly in these countries, the predictions of important increases in living costs were not borne out by experience. The United Nations *World Economic Report for 1949-50* says (p. 323): "In all cases in which devaluation was expected to result in increased import prices, with the exception of France, the actual increase turned out to be less—sometimes substantially less—than the anticipated increase." This result was due partly to the fact that United States export commodities were, on the average, cheaper in the first half of 1950 than in the first half of 1949. In the United States the cost of goods imported did not decline very much, as might be anticipated as a result of the cheapening of foreign currencies, because of the increases in prices of exports in the devaluing countries. The world prices of these goods held up fairly well. The decline in the cost of goods imported into the United States in the first half of 1950 was only about 1 per cent compared with the first half of 1949, prior to the devaluations in September, 1949.

While internal costs in the devaluing countries did not rise as greatly as had been anticipated, the later rise in the prices of raw materials throughout the world, particularly accompanying the rearmament program, resulted in a considerable increase in the cost of imports, particularly for the United Kingdom and other countries which import raw materials. This rise in costs applied to countries which did not devalue as well as to those which devalued.

The foreign exchange reserves of the United Kingdom (i.e., the sterling area) and other countries increased rapidly after devaluation. United Kingdom reserves increased from £1.350 billion at the end of 1949 to £3.758 billion at the end of March, 1951. In some countries where conditions similarly improved, there was popular discussion of an appreciation of the currency

in order to reduce the cost of imports and to improve the terms of trade.[8]

The experience of Mexico during this period deserves mention. Mexico, like many other countries after the war, suffered from an exchange rate which overvalued the currency, from balance of payments deficits and a decline in monetary reserves. Mexico had not imposed exchange restrictions, so that the purchase and sale of exchange were free. By the middle of 1948, reserves were down to a precarious level. Mexico was unable to obtain additional dollar resources in the United States, and the government had to choose between the imposition of exchange restrictions in order to maintain the existing rate of 4.85 pesos to the United States dollar, or permitting the peso to depreciate to a level determined by demand and supply forces. Mexico chose the latter course and allowed the peso to seek its own level.

The peso depreciated rapidly, although fluctuations were controlled to some extent. Finally in June, 1949, Mexico stabilized the peso at 8.65 to the dollar. The United States Treasury granted Mexico at that time an increase in its stabilization credit. The International Monetary Fund was also prepared to aid Mexico. Inflation of prices in Mexico was checked. Monetary reserves increased greatly following the devaluation and internal stabilization. Mexico received large sums of dollars from United States tourists who were attracted by the low costs in Mexico, also from a repatriation of capital which had previously fled from Mexico, and from an inflow of new capital from the United States. Exports increased and imports decreased. Confidence in the peso became strong; import restrictions were relaxed; trade expanded and Mexico enjoyed substantial prosperity. Economic activity in Mexico climbed to a high level, whereas before devaluation activity was depressed. Government revenues also increased above estimates. Mexico did not draw on the United States credit or on the International Monetary Fund.

[8] In May, 1951, a document prepared by the staff of the Economic Commission for Europe (ECE) proposed an appreciation of European currencies. This proposal was severely criticized in a number of quarters.

The devaluation of the peso was doubtless the major factor in the changed situation, although other factors probably contributed to the improvement, and provides an interesting example of the benefits which are derived from the maintenance of a realistic exchange rate, the absence of excessive restrictions, and a reasonably conservative credit policy.

Rearmament and Accompanying Financial Problems.—The outbreak of the Korean War in June, 1950, introduced a new phase of the international economic and financial scene. The post-devaluation period, beginning in the fall of 1949 (and following the early postwar years of "dollar shortage" and serious maladjustments), had been characterized by increased imports into the United States aided by the end of the mild recession in the United States, a recovery in world production, improvement in cost relationships in the different countries following exchange rate adjustments, an expansion of world trade and a marked alleviation of balance of payments difficulties. Following the beginning of the Korean War in June, 1950, the prices of raw materials experienced a substantial rise, reflecting to a large extent the demands consequent upon the rearmament program. In many countries the monetary supply expanded considerably and inflationary conditions developed.

The increase in prices of raw materials, rubber, tin, wool, copper, etc., together with increased imports of these materials by the United States, benefited materially the raw material exporting countries such as those of Latin America and South East Asia. The rise in prices, however, meant higher import costs for the United States, the United Kingdom, France, and other industrial countries, particularly those engaged in active rearmament. The large United States export surplus was greatly reduced, and the so-called "dollar shortage" accordingly relieved.

A number of exchange rates, however, still overvalue the currency and are not at levels which promote equilibrium without the support of exchange restrictions. Abnormal demands for raw materials and resulting high prices have improved balance of payments conditions, but do not provide a solid basis for continuing equilibrium.

The increased supply of United States dollars available to foreign countries as a result of the expansion in United States imports, in relation to United States exports, led both to an increase in monetary reserves of foreign countries, and an increase in foreign purchases in the United States. In the anticipation of scarcities many countries sought to build up inventories and to acquire goods while they were still available.

The United States was confronted with the problem of allocating commodities in short supply among a large number of buyers, foreign and domestic, which was a return of the situation existing during and after the war. The United States also found it necessary to seek to coordinate with other countries its purchases of scarce materials, to avoid the competitive bidding up of prices of these materials.

The rise in domestic prices in many countries accompanying the expansion of the money supply and the activity consequent upon rearmament, brought about an increase in monetary incomes, with a resulting tendency for these countries to import more heavily. This tendency toward larger imports was in addition to the stimulus to imports resulting from anticipated scarcities and from attempts to build up inventories, as well as from that consequent upon the greater prosperity following higher prices of raw materials exported.

The improvement in the balance of payments position of many countries, the strengthened monetary reserves and the alleviation or disappearance of the so-called "dollar shortage," removed to a large extent the financial basis for discriminatory controls on current transactions. Further improvement, however, was retarded by the maintenance by some countries of exchange rates which required rigid import restrictions. In spite of the great improvement, countries were reluctant to move far in the direction of trade liberalization. Prospects of large and expensive imports in connection with rearmament caused countries to hesitate in trade liberalization. Discriminations and restrictions were also desired for protectionist reasons, as well as because of the uncertainties of the future. The International Monetary Fund in its Second Annual Report on Exchange Restrictions, which was issued in May, 1951, pointed out

this situation, as noted above, and expressed the view that in the light of the improvement of the gold and dollar position many countries were not doing all that they should to reduce or eliminate exchange restrictions.

Certain trade controls are generally recognized as being necessary in order to channel resources toward rearmament purposes and to promote the most effective use of scarce materials. Nevertheless, it is also true that the meeting of rearmament and civilian needs requires an expansion of production and of trade, the most efficient utilization of resources, and, therefore, the elimination of barriers which do not have an economic or military justification.

Important strategic and military matters have required urgent attention and have complicated the problem of trade liberalization, resulting in delay or postponement in the attainment of certain economic objectives. Furthermore, the fundamental differences of opinion between the United States and certain other countries regarding the desirability of trade liberalization still remain.

The North Atlantic Council of the North Atlantic Treaty Organization (NATO),[9] created in 1951 a Financial and Economic Board (FEB) with responsibility for considering and recommending the best use of the financial and economic resources of the NATO countries, and for considering financial and economic problems which arise in connection with the defense program. In order to prevent duplication of effort the Board is instructed to maintain close contact with the work of other international organizations concerned with financial and economic problems, particularly with the Organization for European Economic Cooperation (OEEC). Recommendations of the FEB ordinarily are to the North Atlantic Council, but in certain cases the FEB may send them directly to member governments.

Many of the financial developments during the postwar period, such as those which have to do with the sterling area, the European Payments Union, the International Monetary Fund,

[9] For a list of the members of NATO see page 616.

the International Bank, and foreign aid extended by the United States, have been discussed in other chapters. To avoid repetition these subjects will not be discussed here.

The rapid shifts in international economic conditions which have taken place since the end of the second World War indicate the difficulty of forecasting conditions far in advance, and the need for flexibility in the approach to all international economic problems, including those which may appear at the moment difficult or even insoluble.

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INDEX OF NAMES

INDEX OF SUBJECTS